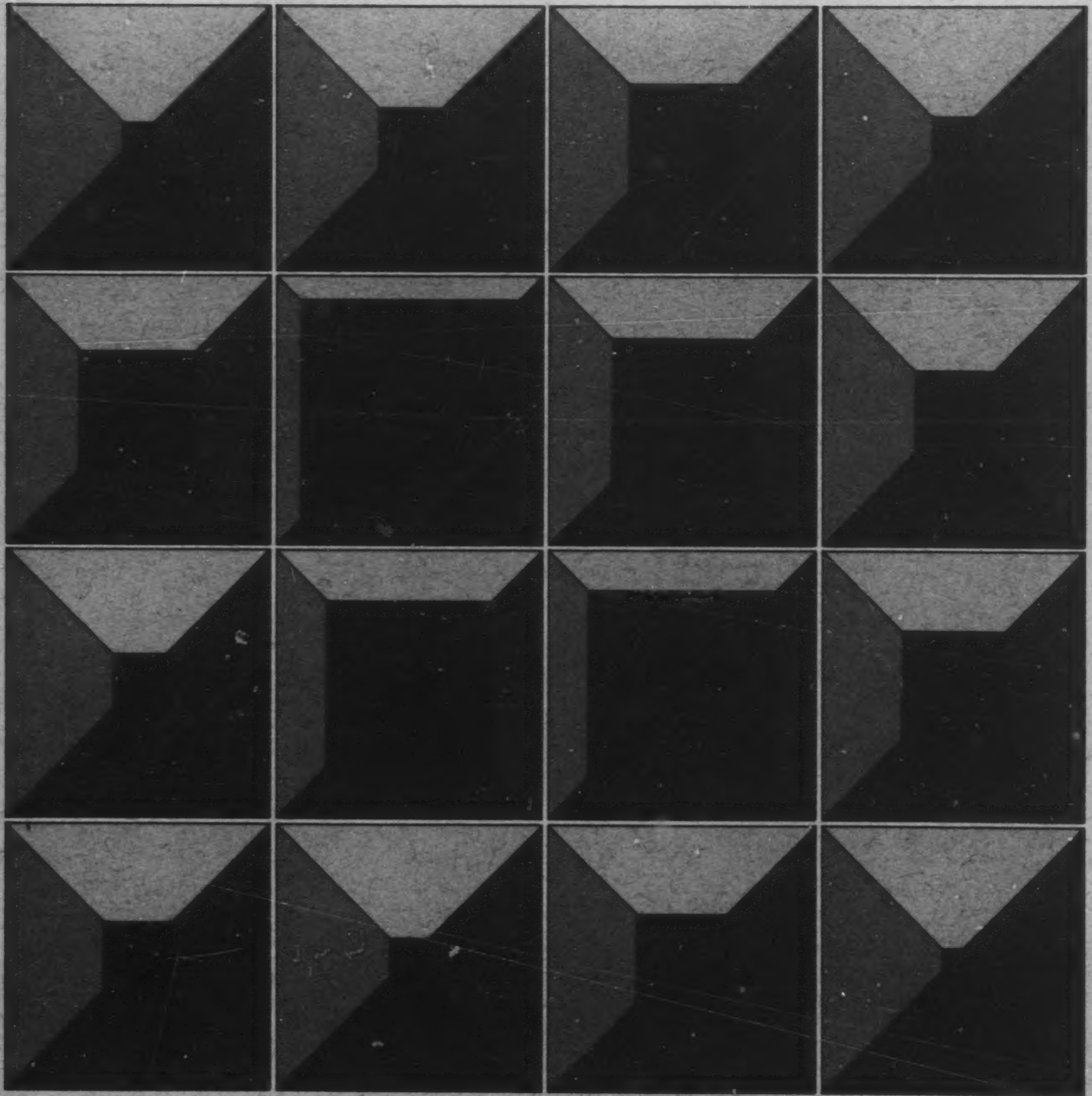
The Housing Finance System and Federal Policy: Recent Changes and Options for the Future

A CBO Study
October 1983

Congress of the United States
Congressional Budget Office



J932-46

THE HOUSING FINANCE SYSTEM AND FEDERAL POLICY: RECENT CHANGES AND OPTIONS FOR THE FUTURE

The Congress of the United States
Congressional Budget Office

PREFACE

The system for financing the construction and purchase of housing has changed significantly in recent years. In the context of this still-evolving housing finance system, the Congress is now considering proposals to alter further the federal role. This paper, requested by the Subcommittee on Housing and Community Development of the House Committee on Banking, Finance, and Urban Affairs, describes recent changes in the housing finance system and analyzes options for further legislation. In accordance with the mandate of the Congressional Budget Office (CBO) to provide objective and impartial analysis, this paper contains no recommendations.

Wilhelmina A. Leigh of CBO's Human Resources and Community Development Division prepared this paper under the supervision of Nancy M. Gordon and Martin D. Levine. Numerous people at federal agencies--including the Federal Home Loan Bank Board, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, and the Government National Mortgage Association--and other organizations provided valuable information for the preparation of this report. Robert Buckley, Bernadette Caldwell, James Carr, Andrew Carron, Frank DeStefano, Diane Dorius, Julia Gould, Jack Guttentag, Thomas Hook, A. Thomas King, Warren Lasko, Warren Matthews, Barbara Miles, Robert Seiler, Cynthia Simon, Wilson Thompson, John Tuccillo, James Verdier, and Kevin Villani reviewed earlier drafts of the report and provided helpful comments. Many members of the CBO staff, including Roberta Drews, Alfred Fitt, Robert Hartman, Marilyn Moon, Larry Ozanne, Lisa Potetz, Frederick Ribe, Pearl Richardson, and Brent Shipp also contributed useful comments and necessary information. Francis Pierce edited the paper. Mary Braxton efficiently and painstakingly typed the many drafts and prepared the paper for publication.

Rudolph G. Penner
Director

October 1983

CONTENTS

PAGE

SUMMARY ix

CHAPTER I. INTRODUCTION 1

- The Existing Housing Finance System 1
- Plan of the Paper 2

CHAPTER II. THE DEVELOPMENT OF THE HOUSING FINANCE SYSTEM AND CURRENT ISSUES 3

- Early Development of the Housing Finance System 3
- Changes in Economic Conditions and Federal Policy Since 1960 5
- Current Issues 9

CHAPTER III. CURRENT HOUSING FINANCE PROGRAMS 11

- Regulatory Policies 11
- Direct Market Intervention 17
- Tax Provisions 23

CHAPTER IV. RECENT CHANGES IN THE MARKET AND IN FEDERAL POLICY 29

- Changes in the Housing Credit Sector 29
- Changes in Federal Policy 30
- Resulting Changes in the Mortgage Market 42

CHAPTER V. POLICY OPTIONS 49

- Increasing Market Efficiency 49
- Altering Federal Subsidies 69

CONTENTS (Continued)

PAGE

APPENDIX A. ADDITIONAL INFORMATION ON FEDERAL HOUSING FINANCE INSTITUTIONS ········· 79

APPENDIX B. RECENT HOUSING FINANCE LEGISLATION AND CHRONOLOGY OF REGULATORY ACTION··· 85

APPENDIX C. ALTERNATIVE MORTGAGE INSTRUMENTS··· 93

APPENDIX D. ADDITIONAL INFORMATION ON SOURCES AND FLOWS OF MORTGAGE FUNDS···························· 97

TABLES

PAGE

TABLE 1. HOUSING FINANCE-RELATED POLICIES AND PROGRAMS 12

TABLE 2. PERCENTAGE DISTRIBUTION OF INTEREST-BEARING LIABILITIES AT SAVINGS AND LOAN ASSOCIATIONS, SELECTED YEARS, 1966-1982 34

TABLE 3. PERCENTAGE SHARE OF MORTGAGE LOAN ORIGINATIONS, NET ADDITIONS TO OUTSTANDING MORTGAGE DEBT, AND OUTSTANDING MORTGAGE DEBT HELD BY SELECTED CREDIT SOURCES, 1978-1982 43

TABLE 4. OUTSTANDING FEDERALLY UNDERWRITTEN MORTGAGE-BACKED SECURITIES, 1970-1982 46

TABLE B-1. RECENT HOUSING FINANCE LEGISLATION.......... 86

TABLE B-2. CHRONOLOGY OF RECENT HOUSING FINANCE REGULATIONS 88

TABLE C-1. SUMMARY OF ALTERNATIVE MORTGAGE INSTRUMENTS 94

TABLE D-1. ORIGINATIONS OF FEDERAL HOUSING ADMINISTRATION-INSURED AND VETERANS ADMINISTRATION-GUARANTEED RESIDENTIAL MORTGAGE LOANS BY PROPERTY TYPE, 1970-1982 .. 98

TABLE D-2. GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA) MORTGAGE-BACKED SECURITIES PROGRAM--COMMITMENTS AND SECURITIES GUARANTEED, 1968-1982 99

TABLES (Continued)

PAGE

TABLE D-3. FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA) PURCHASES AND SALES OF ONE- TO FOUR-UNIT MORTGAGES, 1968-1982 100

TABLE D-4. FEDERAL HOME LOAN MORTGAGE CORPORATION (FHLMC) MORTGAGE ACTIVITY: PURCHASES, SALES, AND HOLDINGS BY TYPE, 1970-1982 101

TABLE D-5. DISTRIBUTION OF ORIGINATIONS OF LONG-TERM MORTGAGE LOANS ON ONE- TO FOUR-UNIT HOUSES BY TYPE OF FINANCIAL INSTITUTION, 1970-1982.............. 102

TABLE D-6. DISTRIBUTION OF NET ADDITIONS TO HOME MORTGAGE DEBT, BY TYPE OF INSTITUTION, 1970-1982 103

TABLE D-7. DISTRIBUTION OF HOME MORTGAGE DEBT OUTSTANDING, BY TYPE OF INSTITUTION, 1970-1982 104

SUMMARY

The housing finance system--the complex system of mortgage lending that enables buyers of houses to finance their purchases--is currently undergoing a transition. After operating as a highly regulated segment of the credit sector during a long period of relative economic stability, the housing finance system was jolted in recent years by rising interest rates. The federal response has been to ease the regulations that formerly governed mortgage lenders, reducing the insulation of housing finance from broader credit markets. Issues now arise as to whether further changes in federal policy might smooth the ongoing transition, and what the government's future role ought to be in the allocation of credit to housing.

DEVELOPMENT OF THE HOUSING FINANCE SYSTEM

The present housing finance system developed over the past half-century through a series of changing federal policies. These policies had to do with the regulation of private lending institutions, the issuance of mortgage insurance and other services, and tax provisions affecting housing.

The Early Years

Federal intervention in the housing finance system began in the 1930s in response to the widespread defaults and foreclosures that occurred during the Depression. Initially, the government offered federal charters to the existing private savings and loan associations and gave them the mission of providing funds for mortgage loans. It also insured their deposits, thereby encouraging savers to place their funds in mortgage lending institutions. Also, mortgage insurance programs were instituted to reduce the risk faced by lenders in making mortgage loans.

These policies, together with previously enacted federal income tax provisions allowing homeowners to deduct mortgage interest and property tax payments from taxable income, contributed to a sharp rise in homeownership--from 48 percent to 63 percent of all households between 1930 and 1970. They also resulted in a system of mortgage finance characterized by long-term, fixed-rate mortgage loans provided mainly by savings and loan associations and mutual savings banks out of funds in their short-term deposit accounts.

Recent Developments

This system operated well for many years, but by the middle of the 1960s rising interest rates and policy responses to them began to create difficulties. Higher interest rates on short-term deposits at mortgage lending institutions led to higher mortgage interest rates. To hold down interest expenses for the major mortgage lending institutions the federal government in 1966 established an interest rate ceiling on their deposit accounts. The limit was set higher than a comparable ceiling governing accounts at commercial banks to give mortgage lending institutions an advantage in attracting the deposits of small savers. Although the ceiling was increased gradually, depositors withdrew their money from the mortgage lending institutions at times when interest rates on other investments rose well above the cap.

During the late 1960s and early 1970s, in part to help mortgage lenders replenish their loanable funds, the federal government expanded its role in the "secondary" mortgage market through which lenders sell mortgages or mortgage-backed securities (MBSs) to investors. In 1968, an existing agency--the Federal National Mortgage Association (FNMA)--was partitioned, creating a tax-paying, federally chartered quasi-private FNMA with a line of credit to the U.S. Treasury, and a new government agency, the Government National Mortgage Association (GNMA), which guaranteed privately-issued MBSs backed by government-insured or -guaranteed mortgage loans. The government also established the Federal Home Loan Mortgage Corporation (FHLMC)--a publicly managed corporation under the aegis of the Federal Home Loan Bank Board and capitalized through the sale of stock to the Federal Home Loan Banks--to facilitate secondary market transactions for the savings and loan associations. These secondary market agencies have expanded the sources of credit for housing by transforming mortgage loans into more liquid and more marketable instruments, thereby enhancing the efficiency of the housing finance system.

Although the programs of these credit entities fostered an active secondary market in mortgages during the 1970s, they did not redress the problems mortgage lending institutions had in attracting and holding deposits. What is more, with interest rates continuing to rise through the 1970s, and with rates paid on deposits by savings and loan associations approaching the yields on their portfolios of fixed-rate long-term mortgages, mortgage lending institutions began to find their profitability threatened in the early 1980s.

The federal government responded to these problems by partially deregulating federally chartered depository institutions in several steps. First, mortgage lending institutions were allowed to pay market-determined interest rates on selected deposit accounts to help them compete for funds, and they were authorized to offer adjustable-interest-rate mortgages to help them match their investment returns with their interest expenses. Subsequently, their lending authority was broadened to cover a wider range of assets other than residential mortgages, and incentives provided through the tax system for them to invest in residential finance were reduced.

Even with deregulation initially exacerbating the profit squeeze for mortgage lenders because their cost of funds rose more rapidly than the yields on their investments, the longer-run effect has been to integrate more fully the housing credit sector with broader credit markets. Although savings and loan associations continue to originate more than one-third of all new mortgages, they now sell a high proportion of them in the secondary market, often through the federally sponsored credit entities operating there. As a result, depository institutions now provide a smaller proportion of all net additional mortgage credit, while other sources--mainly investors in mortgage pools--provide an increasing share.

ISSUES AND OPTIONS

Two issues now arise regarding future federal housing finance policies. The first is how to increase the efficiency of the housing finance system. Although recent market and policy changes have lessened the insulation of the housing credit sector, impediments may remain that increase the cost of the mortgage lending process. A second issue is whether adjustments are warranted for the present system of federal subsidies to housing--to reduce the overall advantages of housing compared with other investments such as business plant and equipment, and/or to make it easier for low- and moderate-income households to afford housing in a high-interest-rate environment.

Increasing Market Efficiency

Numerous proposals have been made recently to increase the efficiency of the partially deregulated housing finance system. Specific options reflect differing views regarding the net impact of present federal policies, but none would involve returning to the highly regulated system of the past. Also, while some actions might improve the efficiency of the housing finance system, housing would remain a highly cyclical sector of the economy, since it is necessarily sensitive to interest rate fluctuations.

Expanding Federal Housing Credit Activity. One set of options would involve expanding federal mortgage insurance or secondary market programs to cover certain credit subsectors that are not now served, because they developed or expanded only recently, after federal programs were already in place.

--Expand eligibility of alternative mortgage instruments for federal insurance and guarantees. Expanding the types of mortgage instruments eligible for insurance or guarantees under the programs of the Federal Housing Administration (FHA) and the Veterans Administration (VA) could facilitate mortgage lending. Although depository institutions offer many alternative mortgage instruments, the FHA insures and the VA guarantees only those that vary the payment schedule in a predetermined way. Expanding eligibility to include mortgages with interest rates adjusted to match the market over the term of the mortgage could encourage lending institutions to make more such loans, in part because the loans would then be eligible for purchase or pooling in federal secondary market programs. Such a change would increase the contingent liability of the federal government, however, and, given apparent resistance by borrowers to variable rate mortgages, would probably have little effect on the total supply of mortgage credit.

--Expand the secondary market in existing instruments. Another option would be to expand the types of mortgages eligible for purchase by, or pooling in, programs operated by the federal and federally sponsored secondary mortgage market agencies. Examples include loans for manufactured housing and cooperatives, second mortgage loans, and loans insured by state housing finance agencies. Expanding eligibility to encompass these mortgages might significantly affect certain housing submarkets, but would probably have little effect on the average cost of all housing credit.

Similarly, the federal government could raise the limit on the value of mortgages purchased under programs of federally sponsored credit agencies --currently $108,300 for a loan on a single-family home. This would expand the market penetration of these programs but could supplant the activity of private-sector institutions currently operating in the market for large mortgages.

Encouraging Housing Credit Activity by the Private Sector. Another approach would be for the government to encourage private-sector housing credit activity by removing statutory or regulatory impediments to the issuance of private MBSs that are backed by pools of conventional mortgages--that is, mortgages neither insured nor guaranteed by a federal agency. Although several impediments to the development of private conventional MBSs have been eliminated recently, one major hindrance remains--the provisions of the federal tax code under which mortgage-backed securities, unlike corporate securities, are subject to taxation both at the level of the holder of the security and at the level of the party managing the pool of assets backing the MBS. This double taxation can be avoided only if MBSs are passively managed; however, to maximize profitability, MBSs must be actively managed, involving, for example, the substitution of new loans for prepaid ones and the reinvestment of principal payments.

Amending the federal tax code to do away with double taxation of actively managed privately issued MBSs would eliminate a disadvantage they now suffer compared to privately issued nonhousing securities, which are taxed only at the shareholder level. This could do a great deal to encourage the use of privately issued conventional MBSs, which might in turn increase investment in mortgages by a greater number of credit sources, particularly pension plans. On the other hand, depending on how issuing requirements were structured, amending the federal tax code could induce some smaller securities issuers to undertake a new activity for which they might not be adequately prepared. Also, to the extent that such a change increased the overall flow of capital to housing, it would divert investments into a sector of the economy that already enjoys many advantages provided through the federal tax system, unless these advantages for housing investment are modified.

Reducing Direct Federal Housing Credit Activity. A third approach that has been suggested is to reduce federal mortgage insurance or secondary market programs in the hope of stimulating the development of private-sector alternatives. Proposals of this sort reflect the view that federal programs impede the efficient operation of the market by discouraging the private sector and do not lower mortgage interest rates significantly. But if the federal government withdrew, there is no assurance how quickly private institutions would or could fill the void. Therefore, any sharp reduction in the federal role might seriously impede the operation of the housing credit sector in the short run. Cutting back federal activity only gradually or only for selected submarkets would reduce but not eliminate this risk, and might raise mortgage rates slightly in the long run.

Altering Federal Subsidies

Regardless of what changes might be made to improve the efficiency of the housing finance market, the Congress might want to address the related issue of the role of subsidies to housing--particularly those provided through the tax system. Here, two quite different concerns arise. First, despite substantial existing subsidies, low- and moderate-income households find it increasingly difficult to afford to purchase housing in the current high-interest-rate environment. On the other hand, the recent decline in productivity growth has raised concerns that the United States may be allocating too much capital to housing at the expense of other sectors of the economy.

Several changes could be made in federal tax provisions to target subsidies on households that would otherwise find it difficult to afford to purchase homes. Specific options include: extending a more targeted version of tax-exempt revenue bonds to finance single-family mortgages beyond the currently scheduled expiration date of December 31, 1983; establishing a partial tax credit for mortgage interest payments in addition to, or in place of, the deductibility of such payments from taxable income now available to homeowners who itemize; and authorizing tax-subsidized savings accounts to make it easier to accumulate funds for a down payment. These changes would aid those homebuyers who now benefit least (or not at all) from current tax subsidies, but at the expense of larger revenue losses to the government. Repealing the "sunset" on mortgage revenue bonds, for example, could increase federal revenue losses by $2.8 billion over the fiscal year 1984-1988 period.

Other changes could be made to reduce untargeted subsidies for housing--either as a means of financing greater targeted subsidies, or independently, as a means of encouraging the flow of capital to areas of the economy other than housing. One option would be to establish a ceiling on the deductibility of mortgage interest payments from taxable income, or to allow only a fixed proportion of interest payments to be deducted. Such a change would raise the after-tax costs of homeownership for some owners who itemize deductions. While it could be designed to concentrate adverse effects on those in the best position to bear them, it would be difficult to avoid treating similar households differently, because the additional tax burden would depend, among other things, on when the house was bought and, therefore, the interest rate on the mortgage.

Another approach would be to modify favorable tax treatments now available to savings and loan associations and mutual savings banks that invest certain proportions of their assets in mortgages. Such a change would reduce the incentives that these institutions now have to provide funds for mortgages, thereby possibly diminishing the supply in the long run. To the extent that the total supply of mortgage funds was reduced, this approach could also result in somewhat higher mortgage interest rates, while reallocating funds from housing to other sectors of the economy.

CHAPTER I. INTRODUCTION

The housing finance system is currently in a state of flux resulting from changes in the economy and in federal policy. Economic changes, particularly high inflation and interest rates in the recent past, have altered the terms on which housing credit is made available. Federal policy changes--the deregulation of federally chartered financial institutions and changes in the programs of federal and federally sponsored credit agencies--have also affected the housing finance system. The result has been to break down the institutional barriers between housing finance and the broader credit markets, so that housing now competes for funds on a more even footing with other types of investment. This in turn raises issues relating to the continuing federal role in the housing credit system. 1/

THE EXISTING HOUSING FINANCE SYSTEM

The existing housing finance system provides credit through both primary and secondary mortgage markets. The primary market provides funds for mortgage loans, and these loans or securities backed by them are sold in the secondary market. A buyer unable to pay cash for a home obtains a mortgage loan to finance the difference between the purchase price and the down payment. The mortgage loan is typically repaid in monthly installments of principal and interest over a period of up to 30 years. In 1982, approximately $1.1 trillion in mortgage loans on one- to four-unit houses was outstanding, accounting for 20 percent of all private credit outstanding.

A number of institutions and individuals--functioning as lenders, investors, or borrowers--make transactions in the primary and secondary mortgage markets. The major mortgage lenders in the primary market are depository institutions--savings and loan associations and mutual savings banks (together known as thrift institutions), and commercial banks, all of which obtain funds from their despositors. Depository institutions provided

---

1. This paper focuses primarily on the finance system for single-family --that is, one- to four-unit--housing. Although the credit markets for single-family and multifamily housing are intertwined in some respects, there are major differences in the way these types of structures are financed.

two-thirds of the $95 billion of newly originated residential mortgage loans on one- to four-unit houses in 1982. Other lending sources include mortgage bankers, life insurance companies, and individuals selling their homes. The borrowers in the primary market are the households who purchase homes with mortgage loans from these sources. The investors are primarily the stockholders and depositors in the depository institution.

In the secondary mortgage market, individuals and institutions that originate mortgages sell them to investors either as mortgages or as securities backed by pools of mortgages. It is through this market that such sources of capital as pension plans may invest in mortgages, becoming an indirect source of housing credit. The secondary mortgage market may help to lessen somewhat the cyclical instability of the housing market by expanding the sources of funds. However, sizable swings in the volume of home purchases and residential construction with changes in interest rates remain an inherent part of the housing sector, for two reasons. First, the net costs of home ownership vary so greatly with interest rates. Second, a home purchase is a postponable decision.

Federal activity in the housing finance system is intended to increase the efficiency of the housing credit market—that is the pairing of potential lenders, or investors, and borrowers at the lowest possible cost. The federal role includes the regulation of the major primary market lenders, the issuance of insurance and guarantees on privately written mortgages, and the operation of agencies that facilitate transactions in the secondary mortgage market. Federal tax provisions also have an impact on the flow of funds toward housing by lowering its after-tax cost to homeowners and increasing its attractiveness as an investment.

PLAN OF THE PAPER

The remainder of this paper describes recent changes in the housing finance system and presents options for altering the federal role. Chapter II discusses the development of the housing finance system and current issues that have been raised about it. Chapter III describes existing federal housing finance policies and programs in more detail. Chapter IV examines recent market and federal policy changes and resulting shifts in the sources, forms, and cost of mortgage credit. Chapter V presents policy options intended to increase the efficiency of the housing finance system or to alter federal subsidies for housing finance.

CHAPTER II. THE DEVELOPMENT OF THE HOUSING FINANCE SYSTEM AND CURRENT ISSUES

Federal policies toward housing finance have changed over the years with changes in economic circumstances. Although a principal concern has always been to increase the efficiency of the mortgage market, other objectives have also been pursued. In the years immediately following the Depression, policy focused on stabilizing the housing sector to help stabilize the economy. The system that evolved--which featured long-term fixed-rate mortgages provided primarily by highly regulated depository institutions--generally operated efficiently until the inflation and high interest rates of the last two decades jolted both the economy and the housing sector. Recent federal policy changes have resulted in the partial deregulation of mortgage lending institutions and the increased integration of the housing finance system with broader credit markets. These policy adjustments, and the economic circumstances that gave rise to them, now raise issues concerning the future direction of federal housing finance policy.

This chapter first traces the development of the housing finance system, including the changing federal role, and then presents issues now confronting the Congress.

EARLY DEVELOPMENT OF THE HOUSING FINANCE SYSTEM

The federal government began to intervene in the housing finance system in the 1930s in response to widespread mortgage defaults and foreclosures resulting from the Depression. It extended charters to the existing system of private depository institutions known as savings and loan associations, which had been established to provide mortgage loans for their depositors. 1/ The government also undertook to insure the deposits of the

---

1. Mutual savings banks, chartered by the states since 1816, had the primary mission of providing consumer credit. In the early 1950s, the federal government removed the tax exemption of both savings and loan associations and mutual savings banks and established a bad debt reserve deduction to encourage investment in residential mortgages by both types of institutions. See Chapter III for a more detailed discussion of private lending institutions and their regulation.

recently chartered mortgage lending institutions, and to provide insurance or guarantees for privately written mortgages. 2/

Because deposit and mortgage insurance established the federal government as recourse for losses arising from the mortgage lending process, savers were encouraged to place their funds in the mortgage lending institutions, and lenders faced reduced risks in making mortgage loans. These forms of insurance may have contributed to lower mortgage interest rates than would otherwise have prevailed, thus lowering the before-tax cost of housing. In addition, tax provisions established before the Depression lowered the after-tax cost of housing--principally by allowing homeowners to deduct mortgage interest and property tax payments from taxable income. The importance of these provisions increased over time as marginal tax rates rose, because taxpayers with high marginal tax rates benefited most from them.

Taken together, these policies had several effects. For one, federal intervention in the housing finance system contributed to a sharp rise in homeownership--from 48 percent to 63 percent of all households between 1930 and 1970 alone. 3/ At the same time, the increasing use of the tax provisions that lower ownership costs meant high revenue losses for the federal government. In 1970, for example, the federal revenue loss from the deductibility of mortgage interest on owner-occupied homes was $2.8 billion, and the loss from the deductibility of property taxes on owner-occupied homes was $2.9 billion. 4/

Another result of federal intervention was to help standardize the mortgage loan instrument and the system for financing it. The system that

---

2. The Federal Savings and Loan Insurance Corporation (FSLIC), which provides deposit insurance for savings and loan associations, was established in 1934. One year earlier, the Federal Deposit Insurance Corporation (FDIC) had been established to provide deposit insurance for commercial banks and for many mutual savings banks.

3. In 1980, 66 percent of all households were owners, although by 1982 this figure fell for the first time in decades to 65 percent. Over the years, rising household incomes also played a major role in enabling so large a proportion of households to become owners.

4. Since 1970, the estimated annual revenue loss from all homeownership tax incentives has risen to nearly $40 billion in fiscal year 1983, partly because of rising mortgage interest rates.

evolved featured long-term, fixed-rate mortgage loans provided predominantly by savings and loan associations and mutual savings banks. Because these long-term assets were funded by short-term deposits in the thrift institutions, this financing system worked well as long as long-term rates exceeded short-term ones, and both were stable. This was generally the case for the 20 years immediately following World War II.

CHANGES IN ECONOMIC CONDITIONS AND FEDERAL POLICY SINCE 1960

By the 1960s, rising and increasingly volatile interest rates initiated a chain of problems for the housing finance system, prompting a series of policy adjustments over the next two decades.

To hold down the cost of deposit accounts to thrift institutions--and thereby the interest rate charged on mortgages--the government began to regulate the interest rates that thrift institutions could pay on deposits. In 1966, an interest rate ceiling was imposed on the thrift institutions at a level slightly higher than a pre-existing ceiling for accounts at commercial banks, in order to give mortgage lending institutions an advantage in attracting deposits. 5/ Because deposits at thrift institutions were federally insured, and because few alternative investments requiring only small initial sums of money existed, the thrift institutions were able to maintain their supply of funds from small savers despite the cap on interest rates. Nonetheless, despite occasional increases, the ceiling soon presented problems for mortgage lending institutions when the interest rates available on other investments occasionally rose to levels well above the ceiling. Thrift institutions were then faced with the loss of deposits as investors with large accounts sought to achieve higher yields through alternative investments--a process referred to as disintermediation. 6/

---

5. Regulation Q--the Federal Reserve regulation that sets interest rate ceilings for deposit accounts at the federally chartered depository institutions--was established for deposit accounts at commercial banks in the 1930s and was extended to accounts at savings and loan associations and mutual savings banks in 1966.

6. The net effect of the rate ceiling on deposit accounts on the supply and cost of mortgage credit remains a matter of some disagreement. On the one hand, because the ceiling reduced the cost of funds to thrift institutions, it may have lowered mortgage interest rates as well. On the other hand, the ceiling may also have lowered the volume of deposits, and, in any event, there is some question concerning how

In the late 1960s and early 1970s, the federal government greatly expanded its role in the secondary mortgage market--in part to help primary-market lending institutions replenish their funds. During this period, the government partitioned the existing federal secondary market agency--the Federal National Mortgage Association (FNMA)--creating a taxpaying federally chartered quasi-private FNMA and a new government agency, the Government National Mortgage Association (GNMA). The latter assumed the credit-market-support functions of the original FNMA and established a new guarantee program for mortgage-backed securities. The government also established the Federal Home Loan Mortgage Corporation (FHLMC) as a publicly managed corporation under the aegis of the Federal Home Loan Bank Board to facilitate secondary market transactions of the thrift institutions that are members of the Federal Home Loan Bank System.

Among them, these credit entities could purchase mortgages outright, issue securities backed by pools of mortgages--that is, mortgage-backed securities (MBSs)--and guarantee privately issued securities backed by pools of federally insured or guaranteed mortgages. 7/ The programs of these secondary market entities grew rapidly during the 1970s, as did the availability of federal mortgage insurance and guarantees--expanding the indirect sources of mortgage capital. They did not, however, assist the thrift institutions to attract and hold funds during periods when market interest rates substantially exceeded the ceiling on their accounts. 8/

---

6. (Continued)
much of any interest rate savings was passed along to borrowers. To the extent that the ceiling lowered mortgage interest rates, its effect was to transfer wealth from the small savers who held deposits in thrift institutions to homebuyers who obtained loans from those institutions. For a discussion of the issues surrounding the impact of deposit account ceilings on the cost of credit, see A. Thomas King, "The Deposit Rate and the Mortgage Rate: Does Regulation Q Promote Homeownership?" Research Working Paper No. 85, Office of Economic Research, Federal Home Loan Bank Board (September 1979).

7. A mortgage-backed security (MBS) is investment paper that derives its value from the mortgages assembled in a pool to back it. MBSs are discussed in greater detail in Chapter III in connection with the operation of federal secondary market credit entities.

8. The Federal Home Loan Bank System--which oversees the thrift institutions--advances funds to its member institutions to meet their needs during periods when they attract insufficient deposits.

By the late 1970s, the rise in interest rates to historic highs--fueled by rising inflation rates--had created substantial difficulties both for borrowers and for the thrift institutions. Borrowers faced more costly mortgage payments on larger loan amounts financed at higher interest rates. 9/ For the thrift institutions, as elevated rates made savers increasingly eager to seek higher yields, competing investments in the form of money market mutual funds developed, exacerbating disintermediation. 10/ Also, although the interest-rate ceiling on deposits did not keep pace with the rates paid on alternative investments, it was raised enough to approach the thrift institutions' yields from their portfolios of fixed-rate long-term mortgages. Because the profitability of thrift institutions is determined by the relationship between the interest-rate cost of their short-term deposits and the yield from their long-term, fixed-rate assets (mainly mortgages), the rise in market interest rates--and the resulting rise in the interest-rate ceiling on deposits--threatened the profitability of these institutions.

The most recent federal response to changing circumstances has been to deregulate partially the federally chartered financial institutions that had become the core of the housing finance system. Beginning in 1978, mortgage lending institutions were permitted to offer accounts and certificates of deposit that were subject to market-determined interest ceilings, in order to attract new funds with which to finance additional lending at profitable rates of interest. Initially, however, these accounts led to a shift in deposits from lower-interest to higher-interest instruments without attracting large amounts of new funds. As a result, by 1980 total interest expenses exceeded interest income, causing large losses for the savings and loan industry and the failure or forced merger of many institutions. More recently, the availability (since December 1982) of small-denomination accounts not subject to any interest rate ceiling has succeeded in attracting new funds to the thrift institutions, while lessened inflation has moderated the profit squeeze for the institutions.

---

9. Although nominal interest rates were high, the high inflation made real interest rates low enough to sustain a high level of homeownership demand during this period.

10. A money market mutual fund is an investment company that pools investors' funds for investment in high-grade, short-term debt and bank deposits paying market rates of return. Examples of these money market instruments include U.S. Treasury bills, certificates of deposit, and commercial paper. Owners of a money market mutual fund hold proportional shares in the entire pool of securities in which a fund invests and pay taxes on distributions from the fund. In addition to their investment features, most money market mutual funds offer check-writing redemption features.

Deregulation has also affected the asset side of the ledger for thrift institutions. Beginning in 1979, savings and loan associations and mutual savings banks were permitted to offer mortgages on which the interest rate varies with market conditions over the life of the loan, providing variable-rate assets to match lending institutions' market-determined rate liabilities. Also, since 1980, the lending authority of these institutions has been broadened, permitting thrifts to devote some share of their assets to consumer, agricultural, commercial, and corporate loans. 11/ Although these expanded asset powers may eventually reduce the concentration of savings and loan associations and mutual savings banks on mortgage lending, the remaining incentives provided through the federal tax system and the greater familiarity of thrift institutions with residential finance have thus far kept them focused heavily on housing.

Another effect of federal policy shifts has been to expand the sources of mortgage credit and more fully integrate the housing credit sector with the rest of the economy. For example, although savings and loan associations still originate more than one-third of all new mortgages on single-family homes (more than any other single source), other sources--particularly mortgage bankers--now account for an increased share of the total. At the same time, depository institutions are much more likely either to sell the mortgages they originate or to pool them to back securities that are subsequently sold--often through programs operated by federally sponsored secondary mortgage market entities. As a result, thrift institutions now provide a smaller proportion of all net additions to mortgage credit, and other sources--primarily the investors in mortgage pools--account for an increasing share.

The forms of mortgage credit available and its cost have also changed. Mortgage loans on which the payment schedule varies in a predetermined way in order to reduce the burden on homebuyers in the early years, and mortgages on which the interest rate varies with market conditions over the life of the loan are now available. To date, however, few borrowers have been willing to accept the risk associated with the latter types of loans, at least on the terms they are currently offered. In addition, the cost of mortgage credit has varied with recent changes in interest and inflation rates.

---

11. Also in 1980, state ceilings on mortgage interest rates for first mortgages were preempted by the federal government, allowing mortgage lending institutions to realize higher returns on their loans.

CURRENT ISSUES

Continuing high rates of interest (especially high rates in real terms), the deregulation of mortgage lending institutions, and the resulting increased integration of the housing credit sector with broader credit markets raise two general issues concerning future federal housing finance policies.

The first issue is what changes, if any, in federal policies would make the existing housing finance system operate more efficiently. Historically, federal intervention resulted in a highly regulated and partially insulated housing credit sector. Now that the insulation has been reduced--largely through increased reliance on secondary mortgage markets--the question arises whether conditions remain that unnecessarily increase the cost of housing credit by impeding the flow of funds to housing. Part of this question is whether some federal programs themselves constitute impediments by discouraging the development of private-sector alternatives.

Numerous actions have been suggested to increase the efficiency of the housing finance system. While they reflect different assumptions regarding the net effect of present federal activity, none would return to the highly regulated system of past decades, although some options would expand the federal role somewhat. Alternative approaches include: expanding federal mortgage insurance or secondary-market programs to cover subsectors that are not now served; removing remaining regulatory and statutory impediments to broader investment in certain private mortgage-backed securities; and reducing direct federal mortgage insurance or secondary-market programs in the hope of stimulating increased private activity.

A second general issue is whether adjustments should be made in the present system of federal subsidies for housing. This issue arises from two quite different--but not necessarily contradictory--concerns. First, despite substantial benefits for homeowners provided through the federal income tax system, a combination of steep increases in housing prices and sharply higher interest rates in the recent past have made it increasingly difficult for low- and moderate-income households to afford to purchase homes, especially their first ones. At the same time, there is growing concern that the current volume of subsidies for homeownership may already tilt overall investment incentives unduly toward owner-occupied housing and away from other uses, potentially contributing to declining rates of growth in other sectors of the economy. Increasing subsidies for selected groups could address the first concern, while reducing untargeted subsidies for housing could address the second. Either approach could be pursued separately, or both could be undertaken simultaneously, with some or all of the savings resulting from reducing untargeted benefits used to finance increases in targeted subsidies.

The remainder of this paper is intended to assist the Congress in considering possible policy changes to address these issues. The following chapter describes current federal programs, the next one details recent market and policy shifts, and the final chapter presents options to deal with the two issues discussed here.

CHAPTER III. CURRENT HOUSING FINANCE PROGRAMS

A wide variety of federal policies and programs directly and indirectly affect the housing finance system. Although general monetary and fiscal policies of the government have broad impacts on the housing finance system by affecting the supply and cost of all forms of credit, these policies are beyond the scope of this paper. The specific housing policies discussed here--and summarized in Table 1--include:

- Regulation of the private lending institutions that invest in housing;
- Direct intervention to insure and guarantee mortgages and to provide a secondary market to generate additional mortgage funds; and
- Favorable tax treatments of investment in housing by homebuyers, developers, and lending institutions.

REGULATORY POLICIES

Federal regulation of depository institutions, of pension plan investments, and of securities registration all influence the housing finance system.

Regulation of Depository Institutions

Federal regulation of depository institutions--savings and loan associations, mutual savings banks, and commercial banks--affects both the supply and cost of mortgage credit, directing investments by some types of institutions toward residential mortgages, controlling interest rates on certain deposit accounts, and advancing funds to the institutions. In addition, the federal government provides deposit insurance to encourage depositors to establish accounts without concern about the riskiness of the portfolios of the depository institutions.

Different types of depository institutions were originally established to serve different purposes, and incentives provided by regulations and the federal tax system (discussed later in this chapter) have resulted in their

TABLE 1. HOUSING FINANCE-RELATED POLICIES AND PROGRAMS

Policy	Purpose	Program Operation
	Regulatory Policies a/	
Regulation of depository institutions	Establish criteria to foster the solvency of institutions and the safety of deposits. Encourage investment in residential mortgages.	Provide deposit insurance. Originally specified the asset/liability structure of these institutions through regulatory incentives and tax laws. Later established interest rate ceilings for deposit accounts.
Regulation of pension plan investments	Protect solvency of pension plans.	Specify prohibited and permissible investment transactions.
Regulation of securities registration	Protect investors by increasing information about issues.	Specify terms under which issues are made available for purchase by investors.
	Direct Market Intervention	
Federal mortgage insurance and guarantees	Encourage lenders to make mortgages for certain population groups, areas, and types of housing.	The FHA b/ insures lenders against losses from default on mortgage loans. The VA c/ guarantees lenders against losses from default on loans made to veterans. The FmHA d/ has the authority to guarantee privately written mortgages in rural areas.
Secondary market intervention	Establish secondary market in mortgages to increase supply of funds for housing.	Federal agencies and federally sponsored credit entities guarantee certain mortgage-backed securities issued by private lenders, purchase privately written mortgages, and issue securities backed by pools of privately written mortgages. e/

(Continued)

TABLE 1. (Continued)

Policy	Purpose	Program Operation
	Taxation	
Federal tax subsidies to homeowners	Encourage homeownership.	Mortgage interest and property tax payments are deductible from taxable income. f/ Capital gains from sale of residence are tax-exempt if rolled over into successive home purchase. Up to $125,000 in capital gains from sale of residence not rolled over are tax-exempt after age 55.
Federal tax subsidies to rental project developers	Encourage development of rental housing.	Favorable depreciation and limited recapture of excess depreciation after the sale of property are permitted on all rental housing, along with the rapid amortization of construction period interest and taxes. Additional benefits are available for low-income rental housing and historic structures.
Federal tax exemption of interest on state and local mortgage revenue bonds	Enhance ability of state and local entities to fund housing and other developments.	State and local entities issue federally tax-exempt mortgage revenue bonds, the proceeds of which are lent to financial institutions that relend them to homebuyers.
Special tax treatment for lending institutions	Encourage thrift institutions to invest in mortgages.	Thrift institutions are allowed to deduct as much as 34 percent of total taxable income as an addition to bad debt reserve if specified percentage of assets is held in mortgages and other qualifying forms.

(Continued)

TABLE 1. (Continued)

a. State and local regulations that specify the terms and the forms of investments by state and local government employee pension plans are not discussed in this paper. Other state regulations governing the operation of fiduciary institutions are also not covered here.

b. Federal Housing Administration.

c. Veterans Administration.

d. Farmers Home Administration.

e. In addition, the Farmers Home Administration guarantees and sells securities to finance its subsidized direct homeownership and rental housing loans.

f. Purchasing housing is an investment, and the interest payments on investments normally are deductible from taxable income. Considered in this manner, the advantage of the deductibility of mortgage interest payments comes from the fact that the implicit income from forgone rent payments on owner-occupied housing is not taxed.

maintaining different investment patterns. The savings and loan associations were intended principally to provide home mortgage loans, and their portfolios consist predominantly of those. Mutual savings banks hold somewhat more diversified portfolios, reflecting the intent that they provide consumer credit as well as residential mortgage loans. Commercial banks--which were federally chartered before savings and loan associations and mutual savings banks--were not created to encourage investment in home mortgages and, in fact, hold the most diversified portfolios among the depository institutions.

Several government entities regulate the depository institutions. The Federal Home Loan Bank Board (FHLBB) regulates and examines federally insured savings and loan associations--both federally chartered and state-chartered institutions--as well as federally chartered mutual savings banks. The Federal Deposit Insurance Corporation (FDIC) regulates state-chartered, federally insured mutual savings banks and state-chartered, federally insured commercial banks that are not members of the Federal Reserve

System. The Comptroller of the Currency regulates federally chartered commercial banks, all of which are members of the Federal Reserve System and are insured by the FDIC. 1/ The Federal Reserve Board regulates state-chartered commercial banks that are members of the Federal Reserve System. Finally, the Depository Institutions Deregulation Committee (DIDC) determines the rate to be paid on deposit accounts at all depository institutions. 2/ In addition to exercising regulatory authority, both the Federal Home Loan Bank System and the Federal Reserve System can supplement funds at the depository institutions. 3/

Federal deposit insurance began during the Depression to encourage persons to place their funds in lending institutions by insuring accounts up to certain limits. The FDIC was created in 1933 to insure deposits of commercial banks and most mutual savings banks. One year later, the Federal Savings and Loan Insurance Corporation (FSLIC) was established under the aegis of the FHLBB to insure the accounts of all federal savings and loan associations, qualified state-chartered building and loan associations, homestead associations, and cooperative banks, and to prevent their defaults. Both the FDIC and the FSLIC collect premiums from depository institutions to finance the insurance, and in both instances the insurance

---

1. All federally chartered commercial banks are termed national banks.

2. The DIDC was established by the Depository Institutions Deregulation and Monetary Control Act of 1980 to oversee the phasing out of interest-rate ceilings on deposit accounts. The Committee is comprised of the Comptroller of the Currency as a non-voting member and the following voting members: the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Board of Directors of the FDIC, the Chairman of the FHLBB, and the Chairman of the National Credit Union Administration.

3. The Federal Home Loan Bank System provides advances to member institutions--federally insured savings and loan associations and those mutual savings banks that are members of the Federal Home Loan Bank System--to bolster their liquidity and to foster greater mortgage lending activity. The Federal Reserve Banks provide advances to assist depository institutions in need of liquidity. Although all depository institutions with reservable deposit accounts have access to the Federal Reserve discount window--a facility that provides advances on the basis of eligible collateral, usually Treasury bills valued at par--the discount window is mainly used to meet short-term borrowing needs of member banks.

funds consistently have been able to cover claims. 4/ In addition to encouraging persons to invest their funds in lending institutions, deposit insurance may provide insured institutions with a price advantage in attracting funds, while encouraging those institutions' managers to undertake riskier investments than they otherwise might, since the safety of the investments is of less concern to the insured depositors.

Regulation of Pension Plan Investments

Federal regulation of investments by private pension plans--a significant source of long-term investment capital--indirectly affects the housing finance system by limiting the extent to which pension plans can invest in mortgages. Specifically, as a result of the 1974 Employee Retirement Income Security Act (ERISA), the Department of Labor regulates the conditions under which investments in mortgages and in securities backed by mortgages can be made. 5/ Because funds put aside for retirement represent long-term assets, and mortgages represent long-term liabilities, pension plans could be an appropriate source of funds for housing credit.

Although recent changes in regulations have encouraged pension plan investment in many forms of mortgages and in securities backed by mortgages, the amount of this investment remains small. This limited investment results in part from lingering concerns of the plans' investment managers about the liquidity and marketability of mortgage-backed securities (MBSs) and in part from remaining regulatory disincentives for investment in MBSs backed by conventional mortgages, that is, mortgages neither insured nor guaranteed by a federal agency. 6/ In addition, the inherent nature of an MBS, with an uncertain income stream and maturity due to the possibility of prepayment of the underlying mortgages, may discourage investment by fund managers.

---

4. In fiscal year 1982 premiums paid to the FDIC amounted to $1.4 billion; premiums paid to the FSLIC were $359 million. Both agencies insure individual accounts up to a maximum of $100,000.

5. The 1974 Employee Retirement Income Security Act (ERISA) governs both noninsured and insured private pension plans that use separate investment accounts.

6. Recent changes in ERISA regulations governing investment in mortgages and MBSs are discussed in Chapter IV.

Regulation of Securities Registration

The federal Securities and Exchange Commission also affects secondary mortgage market transactions. Specifically, the Commission's interpretations of securities laws that demarcate the sizes of security offerings limit the sales of mortgage-backed securities (MBSs) by thrift institutions. By constraining the sale of MBSs by thrift institutions, these regulations have helped discourage the development of a private market for securities backed by pools of mortgages that are neither insured nor guaranteed by the federal government. 7/

DIRECT MARKET INTERVENTION

The federal government directly intervenes in the housing finance sector to stimulate mortgage lending and to establish a secondary market in certain types of mortgages. It does so through mortgage insurance and guarantee programs and through the activities of federally chartered credit entities whose programs facilitate secondary mortgage market transactions. These programs vary in their cost to the government--some charge fees that generally cover costs, while others generate net federal expenses. Because of the programs' functions--insuring or guaranteeing payment on mortgage loans and securities and issuing and marketing MBSs--many create large contingent liabilities for the federal government.

Federal Mortgage Insurance and Guarantees

The federal government insures and guarantees selected privately written mortgages through the Federal Housing Administration (FHA) and the Veterans Administration (VA). In addition, the Farmers Home Administration, an agency within the U.S. Department of Agriculture, has the authority to guarantee privately made mortgages for certain homebuyers in rural areas. These programs increase the willingness of lenders to make loans to borrowers they might otherwise be less likely to serve and on terms they would otherwise be less likely to offer--thus redirecting and potentially expanding the flow of mortgage credit.

FHA Mortgage Insurance. The Federal Housing Administration--established in 1934, and now an agency within the U.S. Department of

---

7. As discussed later in this chapter, programs operated by federal housing credit entities have actively promoted the development of a secondary market in securities backed by federally insured or guaranteed mortgages.

Housing and Urban Development (HUD)--insures lenders against defaults on privately written mortgage loans made for certain single-family units and multifamily projects. The FHA operates more than 40 different programs, financed through four insurance funds. The largest individual program--the Section 203(b) program--provides insurance for mortgages on single-family homes, with moderate limits applying to the value of the loans insured.

Borrowers pay premiums for FHA insurance which, in the case of the principal single-family program, are sufficient to cover losses. Premiums paid under other programs--such as those insuring subsidized mortgages for low- and moderate-income homebuyers and those insuring mortgages on residences located in declining neighborhoods--are not sufficient to cover losses, however. As a result, taken together, the FHA programs run at a loss--amounting to $2 billion in fiscal year 1982. Because fewer new commitments have been made in recent years under some of the more risky programs, the financial position of the FHA funds could improve in the future as the outstanding high-risk mortgages are paid off.

FHA-insured mortgages on single-family homes represent a sizable, but varying, share of that market. Since 1970, for example, FHA-insured Section 203(b) mortgages have averaged 10 percent of all mortgages written on single-family homes in each year. During this period, the FHA's market share ranged from a high of 23 percent in 1970 to about 6 percent between 1973 and 1978.

Over its long history, FHA insurance has contributed substantially to the development of a national mortgage market. Most notably, it has: assisted in the popularization and standardization of the fully amortized, fixed-interest, level-payment mortgage; promoted the use of longer-term mortgages; promoted higher loan-to-value ratios on residential mortgages; assisted in the development of minimum property standards and standardized appraisals; and assisted in the provision of information on risks of default. 8/

Today, private mortgage companies overlap with the function of the FHA, but the availability of FHA insurance may still encourage lenders to

---

8. See James Barth, Joseph Cordes, and Anthony Yezer, "Federal Government Attempts to Influence the Allocation of Mortgage Credit: FHA Mortgage Insurance and Government Regulations," in Congressional Budget Office, Conference on the Economics of Federal Credit Activity, Part II--Papers (September 1981), pp. 159-232.

make loans that they might otherwise consider too risky. 9/ Also, FHA-insured loans are among the most liquid mortgages, both because they are secured by the federal government and because they are eligible for sale or pooling to back securities under programs operated by the federal and federally sponsored secondary market credit agencies. This, in turn, provides a further inducement for lenders to write these mortgages.

The impact of FHA insurance on net housing costs is harder to assess. Currently, the interest rate on most mortgages insured under FHA's principal single-family program--Section 203(b)--is governed by a ceiling that is set periodically by HUD. 10/ Although the maximum allowable interest rate is generally fixed at a level slightly below the then-current market, the borrowers' final costs are not necessarily lower, since mortgage lenders generally charge up-front fees--referred to as "points"--to bring the effective yield up to the market rate. While the number of points--each equal to 1 percent of the loan--that may be charged to a homebuyer is limited in some cases by state law, points paid by the seller may nonetheless be passed along to the buyer in the form of higher house prices.

VA Mortgage Guarantees. The Veterans Administration (VA)--in a program similar to the FHA Section 203(b) program--guarantees privately written home loans for eligible veterans and for military personnel on active duty. The maximum interest rate on VA-guaranteed mortgages is tied to the FHA maximum, with the guarantee available for up to 60 percent of the principal value of the loan or $27,500, whichever is less. As of fiscal year 1983, borrowers under the VA guarantee program may be charged a fee equal to 0.5 percent of the value of the loan. Operating costs of the guarantee program are covered with transfers from a revolving fund used to finance a small direct loan program.

---

9. In mid-1983, the private mortgage insurance companies insured 40 percent of all newly issued unsubsidized insured or guaranteed one- to four-unit mortgage loans while the FHA and the VA insured or guaranteed the rest. Although there is some overlap in coverage by private mortgage insurers and the FHA, there are differences in the groups of borrowers served by the two, relating primarily to borrowers' incomes and locations.

10. Effective May 20, 1982, the greater of 50,000 Section 203(b) mortgages or 10 percent of the mortgage loans insured under Section 203 during the previous fiscal year are eligible for negotiated interest rates. During fiscal year 1983, 50,000 Section 203(b) mortgages became eligible for rate negotiation, because 10 percent of the mortgages insured under the Section 203 program during fiscal year 1982 amounted to only 9,205 loans.

FmHA Mortgage Guarantees. The Farmers Home Administration (FmHA) also has the authority to guarantee privately written mortgages for moderate-income homebuyers in rural areas, although 1981 was the last year in which the agency was authorized to initiate new mortgage guarantees. When available, the guarantee program was limited to households with incomes below $30,000. The agency could guarantee up to 90 percent of the mortgage amount, with interest rates negotiated by the borrower and the lender.

Secondary Market Agencies

The federal government promotes the flow of capital to housing through several secondary market credit entities. These have contributed greatly to the development and trading of MBSs, thereby increasing the efficiency of the housing credit market by making mortgage loans more liquid investments. The increased trading of MBSs also has caused concern about the quality of the instrument to shift from evaluating the underlying loans to evaluating the issuer/guarantor of the securities.

The three major federal secondary market credit entities are the Government National Mortgage Association, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. The Government National Mortgage Association is a government agency that guarantees payments to investors in certain privately issued MBSs. The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation--the former a quasi-private entity and the latter a publicly managed but privately owned corporation--purchase privately written mortgages and issue their own MBSs. (The Farmers Home Administration--FmHA--also guarantees and sells securities, called Certificates of Beneficial Ownership, to finance subsidized direct mortgage loans. Although the FmHA could sell its certificates in the private market and did so until 1975, it currently sells them primarily to the Treasury through the Federal Financing Bank.) [11]

---

[11] FmHA sales of securities to the Federal Financing Bank--an off-budget office within the Treasury Department--constitute borrowing by the agency to finance a direct assistance program, rather than a mechanism for increasing the liquidity of privately written mortgages. Therefore, FmHA's financing practices are not discussed in this paper. For a description of FmHA's housing programs and the procedures used to finance them, see Congressional Budget Office, Rural Housing Programs: Long-Term Costs and Their Treatment in the Federal

The Government National Mortgage Association. Established in 1968 as an agency of the U.S. Department of Housing and Urban Development, the Government National Mortgage Association (GNMA) guarantees privately issued securities backed by pools of mortgages that are insured by the FHA, guaranteed by the VA, or guaranteed by the FmHA. 12/ The GNMA supplements the insurance or guarantee on the underlying mortgages with a guarantee of the payment of MBS principal and interest, backed by the full faith and credit of the federal government. 13/ The federal guarantee of payment makes these the most marketable of all MBSs and has created a strong secondary market in them. 14/ Because the commitment and guarantee fees that GNMA collects from the securities' issuers have thus far covered all operating expenses, the GNMA MBS program has produced net revenues for the government.

The Federal National Mortgage Association. The Federal National Mortgage Association (FNMA) was created in 1938 as a federal financial institution to purchase and resell privately written mortgages; when it was transformed into a privately owned, federally chartered corporation in 1968, the GNMA was created to provide financial assistance for housing subsidy

---

11. (Continued)
Budget (June 1982), and the statement of Rudolph G. Penner, Director of the Congressional Budget Office, on the Honest Budgeting Act of 1983, made before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, on September 19, 1983.

12. The GNMA also provides mortgage interest subsidies for certain types of federally assisted housing through several other programs, which are not discussed in this paper.

13. The first MBSs introduced were called straight passthroughs because investors received proceeds only if payments were made by the initial mortgage loan borrower. The modified passthrough MBSs--the securities currently guaranteed by the GNMA--"pass through" principal and interest payments to investors on the basis of their pro-rata shares in the mortgage pools, whenever payments are due, regardless of whether or not payments have been made by the borrowers on their mortgages.

14. There is also an organized futures market in GNMA-guaranteed securities, through which investors are able to guarantee the expected future price of the securities by fixing it in a contract that can be traded openly. The existence of a futures market further encourages trading in GNMA-guaranteed MBSs, and ultimately provides more funds for mortgage loans.

programs and to guarantee MBSs backed by federally insured and guaranteed mortgages. 15/ The FNMA functions as a financial intermediary--purchasing loans from mortgage bankers and other lenders and holding the loans in its portfolio. These purchases are financed primarily through the sale of short- and medium-term bonds and stock, although the FNMA is authorized to sell securities representing fractional interests in pools of conventional mortgages as well. The FNMA can also sell mortgages but very rarely does so. In addition, the agency has a $2.25 billion line of credit with the Treasury upon which it has never drawn.

The FNMA differs from the GNMA in that the former may make profits or incur losses on behalf of its stockholders, may purchase mortgages outright, and may deal in loans that are neither insured nor guaranteed by the government (so-called "conventional" loans) as well as government-insured or -guaranteed mortgages. GNMA, by contrast, is a government agency that guarantees privately issued securities backed by federally insured or guaranteed loans.

The Federal Home Loan Mortgage Corporation. Chartered in 1970, the Federal Home Loan Mortgage Corporation (FHLMC) purchases and sells conventional residential mortgage loans made by FHLBB member institutions, primarily the federally insured savings and loan associations. The FHLMC received initial capital of $100 million through the sale of nonvoting common stock to the Federal Home Loan Banks and has since issued bonds as debt to these banks to fund its operations. The FHLMC also has authority to issue preferred stock (but has never used it) and can obtain lines of credit from commercial banks. In addition, the FHLBB can use the assets of its member institutions to provide additional credit, if needed, for the FHLMC.

Although the FHLMC may finance its mortgage purchases by issuing bonds as debt, most of its purchases are financed through the sale of MBSs. The FHLMC issues two types of participations in mortgage pools: participation certificates and guaranteed mortgage certificates. The participation

---

15. Although now privately owned, the restructured FNMA was not transformed into a completely private institution in 1968. Even now, the President appoints 5 of the 15 members on FNMA's board of directors, while the remaining members are elected by the shareholders. Also, FNMA's stock issues continue to enjoy a favored market status because they may be issued and purchased through facilities of the Federal Reserve and because they are legal investments for federally supervised institutions. In addition, FNMA stock issues are eligible collateral for Federal Reserve advances and discounts and may be purchased without limitation by national banks.

certificates are similar to GNMA-guaranteed MBSs, in that timely principal and interest payments are made to investors. The guaranteed mortgage certificates are similar to bonds, with semiannual interest payments and annual principal repayments made to investors.

Although the FHLMC is similar to the FNMA in many respects, the agencies differ in their forms of organization, their methods of financing, and their types of mortgage transactions. The two organizations differ because the FNMA is a privately owned, federally chartered agency with publicly traded voting stock, while the FHLMC is a federally sponsored agency of the FHLBB with nonvoting private stock held by the Federal Home Loan Banks. The FNMA finances its mortgage purchases by debt issuances of short- and medium-term bonds and stock, while the FHLMC finances its mortgage purchases primarily by issuing MBSs. Finally, although the FHLMC--like the FNMA--can make transactions in both FHA/VA and conventional loans, the FHLMC has specialized in conventional loan transactions and has made an active market in them.

Differences in the Securities of Secondary Market Credit Agencies. The securities issued or guaranteed by the federally sponsored secondary market credit entities differ in the types of mortgages backing them, the type of guarantee provided, and the role played by the agency. [16] First, whereas GNMA-guaranteed MBSs are backed exclusively by federally insured or guaranteed mortgages, the FNMA MBSs and the two FHLMC instruments may be backed by either conventional or FHA/VA mortgages. Second, while GNMA-guaranteed MBSs carry the full-faith-and-credit guarantee of the federal government, guarantees provided by the FNMA and the FHLMC do not carry that backing and, therefore, are generally considered to be of less value. Finally, while GNMA securities are issued by private lenders (primarily mortgage bankers) and guaranteed by the government, the FNMA and FHLMC certificates are issued, guaranteed, and marketed directly by the agencies. In addition, both the FNMA and the FHLMC own the mortgages backing their security instruments.

TAX PROVISIONS

Four major categories of federal tax provisions affect the housing finance system--either providing incentives to invest in housing or affecting

---

16. For a comprehensive discussion of the many types of mortgage-backed securities see Jack M. Guttentag, "Mortgage Passthroughs: Structure and Policy," prepared for the Mortgage Insurance Companies of America, June 1982.

the supply or price of mortgage credit. The principal tax provisions include those governing homeownership expenses, rental housing investment subsidies, the tax exemption provided for certain mortgage revenue bonds, and the special tax treatment afforded mortgage lending institutions. Together, these tax provisions substantially lower the after-tax cost of purchasing homes and increase the after-tax return on investments in housing, thereby increasing the demand for housing and, indirectly, the supply of mortgage credit.

Homeownership Tax Subsidies

Several tax provisions provide incentives for individuals to become homeowners by reducing the after-tax cost of ownership. These provisions include: the deductibility of mortgage interest and property tax payments from taxable income, the tax exemption for the rollover of capital gains from the sale of residences into successive home purchases, and the one-time exemption from taxes of up to $125,000 in capital gains not rolled over after age 55. 17/

All these elements of the tax code cost the federal government sizable amounts in lost revenue annually. The revenue loss due to mortgage interest deductibility for owner-occupied homes alone is estimated at $25.1 billion for fiscal year 1983, and that due to the deductibility of property tax payments is estimated at $8.8 billion. An additional $3.8 billion in subsidies to homeowners stems from the deferral of income taxes on capital gains from selling homes, while $1.3 billion is estimated to be lost from excluding from taxation $125,000 in capital gains income for persons 55 years of age and older. 18/

Middle- and upper-income households receive most of the benefits from these tax provisions. In 1981, for example, households with annual incomes between $20,000 and $50,000--41 percent of all households--received 63 percent of the benefits from the deductibility of mortgage

---

17. For a more complete description of homeownership tax subsidies, see Congressional Budget Office, The Tax Treatment of Homeownership: Issues and Options (September 1981).

18. Estimates of Federal Tax Expenditures for Fiscal Years 1983-1988, prepared by the staff of the Joint Committee on Taxation for the Committee on Ways and Means and the Committee on Finance, 98 Cong. 1 sess. (March 7, 1983).

interest and 55 percent of the benefits from the deductibility of property tax payments on owner-occupied units. 19/ In that same tax year, households with incomes greater than $50,000--7 percent of all households--realized 29 percent and 37 percent, respectively, of all the benefits from these provisions.

Rental Housing Investment Tax Subsidies

Existing tax laws provide a variety of incentives to invest in rental housing. First, owners of real property may use accelerated depreciation to shelter their investment income from taxes during the early years of ownership, and, when they sell their properties, they may use limited recapture provisions to convert most of their receipts into capital gains--a tax treatment not available to owners of other types of assets. Second, the amortization of construction-period property tax and interest expenses over a ten-year period provides a tax break to developers of rental housing, relative to the tax provisions governing costs incurred in the development of other capital assets. 20/ Moreover, developers of low-income housing may treat construction-period interest and tax payments as current expenses, deducting them from income as they occur. Finally, a substantial tax credit is provided for rehabilitation expenses for income-producing residential and nonresidential property certified as historic; rehabilitation expenses for residential property occupied by low-income households may be depreciated over a five-year period.

Tax-Exempt Mortgage Revenue Bonds

The federal government subsidizes housing credit by permitting state housing finance agencies and local governments to issue revenue bonds, the

---

19. Ibid. Income is measured as expanded income--the sum of adjusted gross income plus minimum tax preferences (mostly excluded capital gains) less investment interest expense (to the extent of investment income)--for the analysis of benefits from the tax provisions. Income is measured as household earnings to determine the proportion of households in the given income categories.

20. Because separate transitional rules were established to gradually increase the amortization period for construction-period interest payments and property taxes from four to ten years for nonresidential and residential real estate, ten-year amortization for nonresidential real estate was established in 1982 but will not be established for residential real estate until 1984.

interest on which is exempt from federal taxes, and to use the proceeds to finance residential mortgages. Because of the tax exemption, the bonds pay rates of interest below those on taxable investments, thus providing a source of mortgage funds that may then be lent at below-market rates.

While the use of bond-financed mortgages for multifamily housing is limited to projects with at least 20 percent of their units occupied by low-income renters, under current federal law, no income restriction applies to the use of tax-exempt bonds to finance mortgages on single-family homes. Although state housing finance agencies have been using tax-exempt mortgage revenue bonds to finance single-family housing since the early 1970s, in 1978 localities also began to issue bonds for that purpose. As a result, the volume of tax-exempt mortgage revenue bonds for all forms of housing increased dramatically in the late 1970s, totaling $14 billion in 1980 alone--more than one-fourth of the volume of all tax-exempt bonds issued. The $10.5 billion of bonds issued in that year to finance single-family home purchases accounted for 1 percent of all single-family mortgage loans made in 1980. The federal revenue loss associated with all the single-family mortgage revenue bonds outstanding in 1980 was $0.7 billion.

In reaction to the rapid growth in the volume of tax-exempt mortgage revenue bonds--and the associated revenue loss--the Mortgage Subsidy Bond Tax Act of 1980 was passed, limiting the volume of tax-exempt financing for single-family housing beginning in April 1979 and eliminating the tax exemption for bonds issued after December 31, 1983. 21/ Under the 1980 act, the annual volume of bond issuances in any state is limited to the greater of $200 million or 9 percent of the average of all home mortgages originated in the state during the preceding three years. The 1980 act also imposed price limits for homes purchased with bond-financed mortgages, required that a portion of bond proceeds be used to finance mortgages in geographically targeted areas, limited eligibility primarily to principal residences of first-time homebuyers, restricted the assumability of the low-rate mortgages, and limited the differential between bond interest rates and interest rates on the mortgages they finance. The 1982 Tax Equity and Fiscal Responsibility Act liberalized the terms of mortgage revenue bonds somewhat. 22/

---

21. Under the 1980 act, mortgage revenue bonds for veterans' housing secured by the general obligation of the issuing state will continue to be permitted after 1983.

22. See Chapter IV for a discussion of the 1982 tax act changes.

The volume of single-family mortgage revenue bonds dropped sharply in 1981 as a result of the limits imposed in 1980, but then grew again in 1982, reaching a level about equal to the 1980 volume. These fluctuations were a response to high market interest rates and housing market conditions as well as to the provisions of the 1980 and 1982 acts. Revenue losses associated with the bonds are expected to total $1.5 billion in fiscal year 1983 and to rise to $1.7 billion in fiscal year 1984, if the December 31, 1983, sunset on bond issues goes into effect. In fiscal year 1988, the revenue loss from the bonds is expected to be $1.5 billion, if the sunset takes effect.

The Taxation of Lending Institutions

Current federal tax law encourages thrift institutions to invest heavily in residential mortgages through an excess bad debt reserve tax deduction. Section 593 of the Internal Revenue Code specifies that a thrift institution may deduct as much as 34 percent of its total taxable income as an addition to its bad debt reserve, if a specified percentage of its assets is held in mortgages or other qualifying forms. 23/ The full 34 percent deduction is available to savings and loan associations with at least 82 percent and to mutual savings banks with at least 72 percent of their assets in qualifying forms. 24/ As the proportion of an institution's assets held in qualifying forms declines, so does the permissible excess bad debt reserve deduction. The deduction reaches zero for savings and loan associations with 60 percent or less of their assets in qualifying forms and for mutual savings banks with 50 percent or less of their assets in qualifying forms.

---

23. Qualifying assets include: residential real property loans; cash; federal government obligations; loans secured by members' deposits; loans secured by church, school, health, and welfare facilities, or commercial property located in an urban renewal or model cities area; student loans; and property used in the conduct of the institution's business.

24. The Tax Equity and Fiscal Responsibility Act of 1982 reduced the maximum excess bad debt reserve tax deduction from 40 percent to 34 percent.

CHAPTER IV. RECENT CHANGES IN THE MARKET AND IN FEDERAL POLICY

Developments since the late 1970s have appreciably altered the housing finance system. Although savings and loan associations continue to originate more mortgages than any other single source, rather than holding mortgages in their portfolios they now either sell a large proportion of them to federally sponsored credit entities or pool them to back securities. In addition, the forms of housing credit have been affected. This chapter discusses recent shifts in the housing credit market and in federal policies, and analyzes their impact on the sources, forms, and cost of mortgage credit.

CHANGES IN THE HOUSING CREDIT SECTOR

As noted in Chapter II, the rapid inflation and elevated interest rates of the late 1970s significantly affected both borrowers--potential homebuyers--and lenders in the interest-rate-sensitive housing sector. Although rising home prices and mortgage interest rates increased the before-tax cost of ownership during this period, the homeownership deductions provided through the tax system and the expectation that future home-price increases would more than keep pace with inflation helped fuel a continued strong demand for housing. 1/ During 1977 and 1978, the increased demand for homes was reflected in increased demand for credit to purchase housing, with buyers expecting to capture sizable enough appreciation in the value of their homes to offset the high interest costs. Also, buyers were willing to take on the burden of mortgages with higher interest rates because they expected their nominal incomes to increase in the future with inflation.

Eventually, however, the rise in mortgage interest rates increased the cost of credit to borrowers sufficiently to reduce demand and, thus, both house sales and housing construction. Between the first quarter of 1978 and the fourth quarter of 1981, the average interest rate for new mortgages on

---

1. Demographic factors also influenced the demand for housing. The 17.4 million increase in the number of households between 1970 and 1980, reflecting the passage of the peak post-World War II baby boom cohort into the years in which many first buy homes, increased housing demand throughout the 1970s, an effect that could continue in the 1980s.

existing homes increased from 9.0 percent to 15.6 percent, and the average percentage of median family income required to support an average mortgage grew from 22 percent to 38 percent. House sales remained roughly constant during 1978, but trended downward from 1979 through 1981, as interest rates rose and expected appreciation in value began to lag. Between 1978 and 1981, total housing units started annually also fell--from 2.0 million to 1.1 million.

Rising interest rates also adversely affected thrift institutions--the major source of mortgage credit. First, these institutions found their supply of credit dollars dwindling as their investors withdrew funds in search of the higher yields that the depository institutions were not allowed to offer at that time. This left the savings and loan associations and mutual savings banks with limited funds with which to finance new mortgage loans.

Thrift institutions also found their earnings squeezed and thus their profitability lessened by the higher interest rates. Formerly, the short-term rates paid on deposit accounts had been fixed by regulation and held below the long-term yields from the mortgage assets in the portfolios of the institutions. The rise in interest rates altered this relationship, however, as the federally imposed ceiling on interest rates on deposit accounts was raised to a level closer to the average yields on outstanding mortgages, many of which were issued in an earlier period of lower interest rates.

CHANGES IN FEDERAL POLICY

Federal housing finance policy has also changed markedly in the past five years--partly in response to the impact of market conditions on thrift institutions. Recent policy changes have altered the regulation of both federal financial institutions and pension plan investments. At the same time, the forms of direct federal market intervention have been changed, and relevant tax provisions have been modified.

Deregulation of Financial Institutions

Since the middle of the 1970s, the restrictions on depository institutions have been eased, enabling them to attract additional funds, expand the types of investments they can make, and be more flexible in choosing their institutional form. This has involved:

- Allowing market-determined-rate deposits;
- Authorizing the use of alternative mortgage instruments;

- Broadening lending powers; and
- Liberalizing chartering options.

Allowing Market-Determined-Rate Deposits. Beginning in the late 1970s, federally chartered depository institutions were authorized to offer several deposit accounts on which interest rates are determined by market conditions. This was the first step toward the legislated elimination by January 1, 1984, of all deposit-interest-rate ceilings that had been established by the Federal Reserve rule commonly known as Regulation Q. [2] Although the new accounts were intended to enable thrift institutions to compete for deposits during periods of high interest rates, restrictions on the alternatives offered by the thrifts still limited their ability to compete with the money market mutual funds offered by other types of private financial institutions. Not until late in 1982 were the thrift institutions allowed to offer money market deposit accounts.

The move toward market-determined-rate deposits at the thrift institutions began in 1978 with the authorization of the six-month Money Market certificate, with a rate ceiling tied to six-month Treasury bill rates and a minimum denomination of $10,000. In January 1980, the longer-term Small

---

[2] The 1980 Depository Institutions Deregulation and Monetary Control Act established March 31, 1986, as the deadline for the complete phase-out of account rate ceilings. The 1982 Garn-St. Germain Depository Institutions Act moved this deadline to January 1, 1984. Regulation Q currently limits the maximum passbook savings account yield to 5.5 percent.

At the same time that interest-rate ceilings on deposit accounts are being phased out, ceilings on mortgage interest rates (usury ceilings) also are being removed. In the 1980 Depository Institutions Deregulation and Monetary Control Act, the federal government preempted state ceilings on first mortgages made by all major types of lenders for home purchases and gave states until April 1, 1983, to override this preemption. Twelve states and Puerto Rico have overridden the preemption, but only one state--Kansas--has both overridden this preemption and established a state ceiling for mortgage loan interest rates. In Kansas, the ceiling was set at 1-1/2 percentage points above the average weighted yield effective on the FHLMC weekly purchase program on the first day of each month. (This ceiling was established before the FHLMC shifted from a weekly to a daily purchase program.)

Savers certificate was introduced, with a minimum maturity of 30 months (and a maximum of 48 months) and a variable ceiling rate--related to the yields on Treasury securities of comparable maturities, and originally capped at 12 percent. The Small Savers certificate was introduced in part to counteract the shortening of deposit liabilities that resulted from the popularity of the Money Market certificates. To enhance their competitiveness the 12 percent cap on the Small Savers certificate has been removed, and the minimum denomination of the Money Market certificate lowered to $2,500, but penalities for premature withdrawal continue to limit their attractiveness compared with money market mutual funds. Finally, between October 1981 and December 1982, one-year, tax-exempt All Savers certificates were issued--with rates set at 70 percent of the average annual yield of the most recent auction of 52-week Treasury bills, and with 75 percent of the funds earmarked for housing loans.

The 1980 Depository Institutions Deregulation and Monetary Control Act continued this trend by allowing federally chartered savings and loan associations and mutual savings banks to establish Negotiable Order of Withdrawal (NOW) accounts--equivalent to interest-earning checking accounts. On January 5, 1983, so-called Super NOW accounts became available, offering higher yields but also requiring larger minimum balances than the regular NOW accounts.

The availability of market-determined-rate accounts and certificates of deposit substantially altered the deposit structure of thrift institutions. Liabilities shifted from those subject to fixed interest-rate ceilings to those subject to interest-rate ceilings tied to various market rates, and to liabilities that are not subject to any interest-rate ceiling. Between 1974 and 1982, for example, the share of savings and loan associations' liabilities subject to fixed interest-rate ceilings declined from nearly 90 percent to less than one-fifth, while liabilities subject to market-determined ceilings grew from zero to nearly one-half of the total, and liabilities subject to no interest-rate ceiling increased from about one-tenth to one-third of the total (see Table 2).

While the availability of market-determined-rate deposits induced many savers to shift funds already held in thrift institutions in order to earn higher rates of return, they attracted few new deposits because the early instruments were poor competitors with money market mutual funds. To rectify this, the Garn-St. Germain Depository Institutions Act of 1982 directed the Depository Institutions Deregulation Committee (DIDC) to allow the establishment of deposit accounts at federal depository institutions that would be "directly equivalent with money market mutual funds."

On December 14, 1982, the new money market deposit accounts were established with a minimum balance no smaller than $2,500. 3/

Because the early market-determined-rate accounts and certificates of deposit shifted funds from low-yielding fixed rate accounts to those yielding higher and varying rates, they helped contribute to a serious earnings squeeze for many thrift institutions whose assets were still concentrated in long-term, low-yield, fixed rate mortgages. Between 1978 and 1982, the profitability of savings and loan associations--measured by retained earnings as a percent of average total assets--declined from 0.84 percent to -0.65 percent, and the profitability of mutual savings banks dropped from 0.58 percent to -0.72 percent. In addition, the number of savings and loan associations declined from 4,002 to 3,343 between the end of 1980 and the end of 1982, and the number of mutual savings banks declined from 463 to 424--reflecting, in large part, the failure or forced merger of financially strapped institutions. 4/

The money market deposit accounts and the Super NOW accounts, on the other hand, have attracted a large volume of new dollars to depository institutions at a time when the cost of variable-interest-rate deposits has fallen relative to mortgage revenues. Between December 1982, when they were first authorized, and the end of the first half of 1983, money market deposit accounts had acquired balances of $105 billion at savings and loan associations. Super NOW accounts--first authorized in 1983--had established balances of $7 billion at savings and loan associations at the end of the first half of 1983. 5/ The availability of these additional funds, combined with the sharp declin[illegible] short-term interest rates since mid-1982, has improved the profit prospects for the thrift institutions. For example, FSLIC-insured savings and loan associations had a net after-tax loss of $1.0 billion in the July-December period of 1982, less than a third of the record loss experienced during the preceding six months. 6/

---

3. On September 30, 1983, the Depository Institutions Deregulation Committee (DIDC) voted to gradually eliminate by January 1, 1986, the minimum-deposit restrictions on the already ceiling-free money market deposit accounts and Super NOW accounts.

4. Andrew S. Carron, The Rescue of the Thrift Industry (Washington, D.C.: The Brookings Institution, 1983), pp. 2 and 6.

5. "Savings and Loan Activity in July," FHLBB News, August 30, 1983, Table 2.

6. "Bank Board Reports Sharp Improvement in Savings and Loan Operating Results in Second Half of 1982," FHLBB News, April 27, 1983.

TABLE 2. PERCENTAGE DISTRIBUTION OF INTEREST-BEARING LIABILITIES AT SAVINGS AND LOAN ASSOCIATIONS, SELECTED YEARS, 1966-1982[a]

Type of Liability	1966	1969	1973	1974	1978	1980	1981	1982
Subject to Interest-Rate Ceilings								
Fixed Rate Ceilings								
NOW Accounts	--	--	--	--	0.1	0.2	1.4	2.0
Passbook Savings	83.1	64.1	43.5	40.1	29.3	18.4	15.2	13.1
Fixed-Ceiling Time	10.9	29.7	48.7	49.4	50.6	20.8	11.1	4.8
Subtotal	94.0	93.8	92.2	89.5	80.0	39.4	27.7	19.9
Market-Determined Ceilings								
Money Market Certificates	--	--	--	--	8.4	32.6	30.5	24.9
Small Savers Certificates	--	--	--	--	--	9.6	16.0	20.8
All Savers Certificates	--	--	--	--	--	--	3.3	1.0
Subtotal	--	--	--	--	8.4	42.2	49.8	46.7
Not Subject to Interest-Rate Ceilings								
Large-Denomination Time Deposits	--	--	1.2	1.7	3.1	7.1	7.9	12.3
Money Market Deposit Accounts[b]	--	--	--	--	--	--	--	6.0
Other Borrowings (Except FHLB[c] Advances)	0.4	0.3	0.8	1.2	2.2	3.0	3.1	3.5
FHLB Advances	5.6	5.9	5.8	7.6	6.3	8.3	10.4	9.8
Retail Repurchase Agreements	--	--	--	--	--	--	1.1	1.7
Subtotal	6.0	6.2	7.8	10.5	11.6	18.4	22.5	33.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: Federal Home Loan Bank Board data. Components may not add to totals because of rounding.

a. Data are for December each year.

b. Money market deposit accounts are the money market accounts first issued by savings and loans in December 1982.

c. Federal Home Loan Bank.

In a move that enhances the flexibility of market-determined-rate deposits for financial institutions, effective October 1, 1983, the Depository Institutions Deregulation Committee (DIDC) eliminated all interest-rate ceilings and minimum-deposit restrictions on newly issued, renewed, or enlarged savings accounts that remain on deposit more than 31 days. The DIDC also eased the minimum penalties that can be levied by financial institutions on customers who withdraw funds from these accounts before maturity. This change affected Money Market certificates and Small Savers certificates. The only remaining accounts with interest-rate ceilings are passbook savings accounts, regular checking accounts (that earn no interest), and regular NOW accounts. The only remaining accounts with minimum-deposit requirements are the money market deposit accounts and the Super NOW accounts.

Authorizing the Use of Alternative Mortgage Instruments. Also beginning in the late 1970s, lending institutions were authorized to make mortgages other than fixed rate, long-term, level-payment loans-- alternatives that became attractive during this period of rapidly rising home prices and high and uncertain interest rates. Beginning in 1979, for example, savings and loan associations and mutual savings banks were permitted to write graduated payment mortgages that involve lower initial mortgage payments rising on a predetermined schedule during the early years of the loan before leveling off. The graduated payment mortgage--and variations on it such as the growing equity mortgage with which payment increases are used to pay off the principal more rapidly--were offered, in part, to make homeownership more easily affordable. These alternative mortgage instruments achieve this objective by reducing the mortgage-payment burden in the early years of a loan. [7]

In 1981, the FHLBB and the Office of the Comptroller of the Currency implemented regulations to permit federally chartered savings and loan associations, mutual savings banks, and commercial banks to originate, purchase, and hold adjustable rate mortgage loans--mortgages with interest rates that can vary over the life of the loan based on market conditions. Adjustable rate mortgages shift some of the interest-rate risk from lenders to borrowers, and, over time, could make the assets and liabilities of depository institutions more compatible, because both would be responsive to current market rates on an ongoing basis. To date, however, the portfolios of thrift institutions remain dominated by fixed-rate level-payment mortgages. Borrowers appear to be reluctant to accept variable-rate loans, although some of this may be due to the pricing and marketing practices of the thrift institutions.

---

7. See Appendix C for a comparison of these and other alternative mortgage instruments.

In 1982, both the FHLBB and the Office of the Comptroller of the Currency proposed amendments to existing regulations to increase the flexibility of depository institutions in designing adjustable rate mortgage instruments. Among other things, these new rules abolish limits on the frequency of interest-rate and payment adjustments and on the magnitude of interest-rate adjustments. [8] The revised FHLBB rules went into effect in 1982; the new rules of the Comptroller of the Currency became final in 1983.

Broadening Lending Powers. Acts passed in 1980 and 1982 further enhanced the lending flexibility of thrift institutions by expanding the instruments in which they can invest. The 1980 Depository Institutions Deregulation and Monetary Control Act authorized federally chartered savings and loan associations to invest up to 20 percent of their assets in a combination of consumer loans, commercial paper, and corporate debt securities; to offer credit card services; and to exercise trust and fiduciary powers. The act also authorized savings and loan associations to make second mortgage loans and to originate residential mortgage loans without geographic restrictions. Federally chartered mutual savings banks were permitted to invest 5 percent of their assets in commercial, corporate, and business loans made within their states or within a 75-mile radius of their home offices.

The Garn-St. Germain Depository Institutions Act of 1982 continued the broadening of lending powers. The 1982 act provided federally chartered thrift institutions with commercial, agricultural, and corporate lending authority without geographic restrictions for up to 5 percent of their assets (7-1/2 percent for savings banks) beginning on the date of enactment of the bill, with the permissible share rising to 10 percent of assets for all thrift institutions in 1984. This commercial lending authority may be in the form of either direct loans or participations, that is, shares of loans. In addition, the act allows a maximum of 10 percent of a thrift institution's capital accounts to be invested in government securities that are obligations of a single governmental unit, with no limit on the number of governmental units.

The impact of these expanded powers on lending institutions and on the housing finance system will depend on the extent to which the new authority is used. Because there are so many residential mortgages in the portfolios of the savings and loan associations, those institutions could invest all of their net new deposits in consumer loans, commercial paper or loans, and corporate debt securities for the next few years before the 20

---

8. See 48 FR 9506 for the final Comptroller of Currency regulation and 47 FR 36612 for the final FHLBB rule.

percent ceiling on these investments would become a constraint. However, these institutions have a strong incentive to limit investments in nonmortgage assets to no more than 18 percent in order to qualify for the maximum bad debt reserve deduction from their taxable income. Also, their expertise in mortgage lending and their limited experience in other areas may make the thrift institutions reluctant to move rapidly into commercial lending.

Liberalizing Chartering Options. As a final means of increasing the flexibility of federally chartered thrift institutions, the 1982 act permitted savings and loan associations and mutual savings banks to convert from one form to the other and, in so doing, to change between the stock and mutual forms of organization. Conversions are subject to rules prescribed by the appropriate regulatory body, but converted associations are entitled to all the benefits of their new form of organization.

The decision to convert depends on the operating position of the depository institution. Conversion from a savings and loan association to a mutual savings bank provides an advantage in the use of the bad debt reserve tax deduction, because mutual savings banks may take the maximum tax deduction while holding only 72 percent of their funds in qualifying assets, compared to the 82 percent required of savings and loan associations. Conversion from a mutual savings bank to a savings and loan association--that is, from a mutual to a stock form of ownership--on the other hand, may be appealing at times, since stockholder-owned institutions have the ability to raise capital beyond that provided by retained earnings, making them better able to absorb interest-rate risks associated with accepting short-term savings deposits and extending long-term mortgage credit. Between October 1982 and October 1983, 113 savings and loan associations have been approved for charter conversion to mutual savings banks while no mutual savings banks have applied for conversion to savings and loan associations.

Changes in the Regulation of Pension Plan Investments

Recent changes in Department of Labor regulations specifying permissible transactions for private pension plans covered by the Employee Retirement Income Security Act (ERISA) also have implications for the housing finance system because they facilitate pension fund investments in mortgage loans. Specifically, on May 18, 1982, the Prohibited Transaction Exemption 81-7 was amended to allow pension plans to invest in a wide range of residential mortgage loans and to purchase mortgage-backed securities issued by the FNMA or the FHLMC, or guaranteed by the GNMA. 9/ In addition, privately assembled pools of conventional mortgages

---

9. Residential mortgage loans eligible for pension plan purchase are those on both newly built and existing single-family homes, on two- to four-

no longer must consist of loans meeting FNMA, FHLMC, or GNMA program criteria in order to qualify for pension plan investment. On January 7, 1983, the Prohibited Transaction Exemption was further amended to allow pension plans to purchase MBSs backed by second mortgages and to authorize the issuance of commitments for forward delivery of MBSs purchased by the plans. 10/

Although these amendments broaden the range of housing-related investments that pension plans can make, they do not encourage secondary market investment in privately issued conventional MBSs--an activity with a sizable potential to channel additional funds into housing investment. The remaining regulatory impediment is the requirement that each conventional mortgage backing an MBS be evaluated on its quality as an investment, while the securities alone are so evaluated for the MBSs backed by FHA-insured or VA-guaranteed mortgages. The Department of Labor considers the Prohibited Transaction Exemption still to be incomplete, however, and suggests that it may be amended further to encourage investment in privately issued conventional MBSs. 11/

Changes in Direct Federal Interventions

Federal mortgage insurance and guarantee programs and the programs operated by secondary mortgage market credit entities have also been changed recently to accommodate new housing market circumstances.

Mortgage Insurance and Guarantees. The FHA and VA mortgage insurance and guarantee programs have been broadened recently to include certain alternative mortgage instruments. Since 1982, the FHA Section 245 graduated payment mortgage program--authorized by the 1974 Housing and Community Development Act but not active until amended in 1977--has included growing equity mortgages. Similarly, the VA now guarantees graduated payment mortgages, growing equity mortgages, and below-market-interest-rate mortgages for which builders pay the rate differential. Neither FHA nor VA programs currently include adjustable rate mortgages, however.

---

9. (Continued)
unit dwellings, on condominiums, on cooperative units, and on manufactured housing.

10. See 47 FR 21241 and 48 FR 895.

11. Options for further amending ERISA regulations are discussed in Chapter V.

Greater interest-rate variability is also now permissible on some FHA-insured loans. In May 1982, the Department of Housing and Urban Development established an experimental program in which a limited number of loans insured under FHA's principal single-family program can be made at interest rates negotiated by the borrower and the lender, rather than being restricted to a maximum set by the Department. 12/

Secondary Market Agencies. The federal secondary market credit entities have also expanded existing programs and developed new ones in recent years.

The GNMA now guarantees securities backed by some kinds of alternative mortgage instruments and has taken steps to increase investment and trading in all its securities. Privately issued securities backed by FHA/VA graduated payment or growing equity mortgages are now eligible for GNMA guarantee. An innovative mortgage-backed security (MBS) program--known as GNMA II and initiated July 1, 1983--is expected to increase trading in GNMA securities through such changes as providing a central paying agent to disburse single checks to owners of several MBSs.

The FNMA has expanded both the types of mortgages it purchases and its MBS programs. For example, the FNMA now purchases growing equity mortgages and also issues and guarantees MBSs backed both by growing equity mortgages and by rapid payoff loans. 13/ The FNMA also now operates a program in which it trades its securities for old, low-yielding mortgages held by the lending institutions. Because the FNMA securities have the same interest yield as the underlying mortgages, they do not directly affect the cash flow of lending institutions. Nonetheless, this so-called swap program appeals to lenders, because the securities they receive are more readily saleable in the secondary market than the mortgages they replace.

---

12. Legislation reported by the Senate Committee on Banking, Housing, and Urban Affairs (S.1338) as amended by the Senate on June 21, 1983, would eliminate the requirement that FHA insurance rates be set by law and would allow them to be set as agreed upon by the borrower and the lender. H.R. 1, as passed by the House of Representatives, also would establish a negotiable rate for FHA insurance programs.

13. Rapid payoff loans are fixed-rate loans on which annual hikes of 2-1/2 to 7-1/2 percent in monthly payments are used to pay off principal in such a way that the home is owned free and clear in 11 to 13 years.

The FHLMC has also recently modified its mortgage purchase program to enhance its ability to provide loanable funds. For example, the FHLMC has begun to buy blanket mortgage loans on cooperative housing projects and to package them in securities for sale to investors. In addition, the FHLMC operates a program, similar to FNMA's swap program, that allows thrift institutions to trade old, low-yielding mortgages for a like amount of FHLMC participation certificates.

Changes in Tax Provisions

Tax laws passed in 1981 and 1982 have altered some of the incentives for investment in rental housing and the subsidies provided to homebuyers through tax-exempt mortgage revenue bonds. In some instances, changes made in the 1981 act were partially offset by provisions of the 1982 law.

The 1981 Economic Recovery Tax Act established a new system for more rapidly depreciating investments in both personal and real property--that is, plant, equipment, commercial buildings, and rental housing. Known as the Accelerated Cost Recovery System (ACRS), it permits capital costs to be recovered for tax purposes using accelerated methods over predetermined periods that are generally unrelated to the useful lives of the assets but are shorter than those in prior law. The act lowered the depreciable life of all real property to 15 years. Over this period, all real property can be depreciated using the accelerated 175 percent declining balance method; low-income rental housing can be depreciated using the 200 percent declining balance method. 14/ When a residential property is sold, only the excess property value depreciated using the accelerated--instead of the straight-line--method is taxed as ordinary income. The rest of the increase in the property's value is taxed as capital gains at a maximum rate of 20 percent--lower than the rate on ordinary income for most investors. In contrast, when nonresidential property is sold, the full increase in its sale value is taxed as ordinary income whether or not its depreciation has been accelerated.

---

14. Under the 1981 act, both new and existing residential rental property (acquired since 1981) may be depreciated using either the 175 percent declining balance method over a 15-year capital recovery period, or the straight-line method over either a 15-, 35-, or 45-year period. Although real property may be depreciated initially using accelerated methods, in order to depreciate the property value to zero in 15 years, at some point, straight-line depreciation must be used. By law, the property owner may shift from accelerated to straight-line depreciation when the value of the depreciation under the straight-line method exceeds that under the accelerated method.

In addition, the 1981 act established 10-year amortization of construction-period property tax and interest expenses for developers of all rental housing and provided a 25 percent investment tax credit for rehabilitation expenses for income-producing residential and nonresidential property certified as historic. All these changes taken together--especially the ACRS--appear to have lessened the relative attractiveness of owner-occupied housing as an investment, compared to other assets such as business plant and equipment and rental housing.

The Tax Equity and Fiscal Responsibility Act of 1982 also shifted the balance of investment incentives. The 1982 act repealed some accelerated cost recovery provisions for assets other than real property that were to have taken effect in 1985 and 1986. In addition, the 1982 act reduced the net value of the tax credit for the rehabilitation of income-producing properties certified as historic--a provision that principally benefits investors in housing. The depreciable value of these properties now must be reduced by 50 percent of the value of this tax credit before cost recovery can begin.

Other provisions of the 1982 tax act modified the tax-exempt mortgage revenue bond program in several ways. The permissible spread between the effective mortgage interest rate and the interest rate on the bonds was increased from 1.0 to 1.125 percentage points, and the proportion of bond-financed mortgages that could go to other than first-time homebuyers was increased slightly. Also, the maximum purchase price limits were raised from 90 percent to 110 percent of the average in non-targeted areas and from 110 percent to 120 percent of the average in targeted areas. In addition, the 1982 act gave state and local housing finance agencies the authority to issue tax-exempt mortgage revenue bonds to finance cooperative unit share loans. 15/

Finally, the 1982 tax act reduced the excess bad debt reserve tax deduction available to thrift institutions. It lowered from 40 percent to 34 percent the maximum proportion of total taxable income that they may treat as an addition to their bad debt reserves if they hold certain minimum shares of their assets in qualifying forms.

---

15. Cooperative unit share loans are loans made to purchasers of individual cooperative units to finance a proportionate share of total project costs.

RESULTING CHANGES IN THE MORTGAGE MARKET

Shifts in credit markets and in federal policies have altered the major institutional sources and the forms of mortgages, as well as the cost of housing credit.

Changes in the Sources of Mortgage Credit

Over the past few years, both the sources of mortgage loan originations and, especially, the disposition of the loans after they are written have changed. Although savings and loan associations continue to originate more long-term mortgages on one- to four-unit homes than any other single source, their share of the total has declined in recent years, reaching approximately 37 percent in 1982--the lowest level since 1970 (see Table 3). More striking has been the change in the placement of mortgages after origination. Before this recent period of inflation and high interest rates, savings and loan associations retained in their portfolios most of the mortgage loans they originated. Recent housing market circumstances, however, have prompted them either to sell most of their newly originated mortgages to the federally sponsored credit agencies or to pool them to back securities.

Because savings and loan associations now retain fewer of their newly originated mortgages, they contribute less of the net addition to outstanding mortgage debt. Between 1978 and 1982, the share of net additions to outstanding mortgage debt accounted for by savings and loan associations declined from 40 percent to -8 percent. 16/ During that same period, the share of all outstanding mortgage debt held by the savings and loan associations declined much less--from 46 percent to 38 percent--reflecting their large accumulated mortgage holdings. The net addition by households to outstanding mortgage debt increased from 10 percent to 24 percent between 1978 and 1982, reflecting the need of households to help provide financing (often through second mortgages) in order to sell their units when interest rates are high.

---

16. The negative percentage reflects the fact that the total outstanding mortgage debt held by savings and loan associations at the end of 1982 was less than the total held at the end of 1981. Data on mortgage debt holdings by the depository institutions do not include the MBSs held in their portfolios, because these data are not available separately. If MBSs were counted as part of the outstanding mortgage debt held by the depository institutions, their reported shares of the net additions to outstanding mortgage debt would rise and the reported share of the net additions held in mortgage pools would decline.

TABLE 3. PERCENTAGE SHARE OF MORTGAGE LOAN ORIGINATIONS, NET ADDITIONS TO OUTSTANDING MORTGAGE DEBT, AND OUTSTANDING MORTGAGE DEBT HELD BY SELECTED CREDIT SOURCES, 1978-1982 a/

Sources	1978	1979	1980	1981	1982 b/
Savings and Loan Associations					
Originations of Mortgage Loans c/	48.6	44.4	45.7	42.8	36.7
Net Additions to Outstanding Mortgage Debt	40.2	32.3	26.8	17.6	-8.0
Outstanding Mortgage Debt	46.2	44.3	42.5	40.7	37.8
Federally Sponsored Credit Agencies d/					
Net Additions to Outstanding Mortgage Debt	8.0	7.7	8.0	6.0	12.2
Outstanding Mortgage Debt	5.3	5.6	5.8	5.9	6.4
Mortgage Pools e/					
Net Additions to Outstanding Mortgage Debt	11.0	18.3	19.5	18.5	38.3
Outstanding Mortgage Debt	8.5	9.9	10.9	11.4	13.5
Households					
Net Additions to Outstanding Mortgage Debt	10.2	13.5	21.4	26.9	24.1
Outstanding Mortgage Debt	8.5	9.2	10.4	11.5	12.4

SOURCES: Data from the U.S. Department of Housing and Urban Development and the Federal Reserve System.

NOTE: Since these figures are from selected sources, the percentages do not add to 100.

TABLE 3. (Continued)

---

a. For additional detail, see Appendix tables D-5, D-6, and D-7.

b. Data on mortgage originations are for the entire year 1982. Data on outstanding mortgage debt are from the third quarter of 1982. Data on net additions to outstanding mortgage debt are from the second quarter of 1982.

c. Originations are of long-term residential mortgage loans on one- to four-unit houses. Originations data are not available for mortgage pools because these do not originate mortgages. Originations data are not available separately for households.

d. Includes the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Federal Land Banks, the Federal Intermediate Credit Banks, and the Banks for Cooperatives.

e. The category "mortgage pools" is comprised not of institutions or individuals but of mortgages--mainly federally insured or guaranteed--grouped together to back securities issued and/or guaranteed for trading in the secondary market. Although the securities are held primarily by institutions, because of the large proportion of securities held by nominees on behalf of investors, it is not possible to apportion the pools accurately by investor institutions. For that reason, mortgage pools are treated separately from other mortgage investments.

These changes in the net additions to mortgage debt and in total mortgage debt outstanding have been made possible largely by greater use of federally sponsored credit agencies and mortgage pools by primary mortgage lenders. Between 1978 and 1982, net additions to outstanding mortgage debt accounted for by federally sponsored credit agencies--the FNMA and the FHLMC--rose from 8 percent to 12 percent of the total, while their share of total mortgage debt outstanding grew from 5 percent to 6 percent. Over the same period, net additions to mortgage debt accounted for by mortgage pools--that is, mortgages grouped together to back securities--increased from 11 percent to 38 percent of the total, and outstanding mortgage debt in pools as a share of all outstanding mortgage debt rose from 9 percent to 14 percent.

Recent increases in the shares of mortgage debt held by federal secondary market credit entities or placed in pools to back securities reflect the steady rise in federally supported secondary market activity since the beginning of the last decade. Between 1970 and 1982, mortgages in pools backing federally underwritten MBSs rose from 0.1 percent to 15.1 percent of all residential mortgage debt outstanding (see Table 4). During the same period, the volume of outstanding federally underwritten MBSs increased from less than $1 billion to $189 billion. The volume of outstanding GNMA MBSs rose fairly steadily over those years from $0.4 billion in 1970 to $119 billion in 1982. The volume of FHLMC MBSs outstanding rose much more slowly during the 1970s but jumped to $56 billion in 1982. FNMA MBSs first appeared in 1981, and by the end of 1982 nearly $15 billion of them were outstanding. The majority of the increase between 1981 and 1982 can be attributed to the swap programs operated by both the FNMA and the FHLMC.

Although complete data on private-sector MBS activity are not available, private activity has been slower to develop than federally sponsored activity. The first major issues of private conventional MBSs--by the Bank of America and the First Federal Savings and Loan Association of Chicago--did not take place until 1977. These publicly placed issues--that is, issues sold on the market through competitive bidding--were followed by very few additional private issues between that year and 1981. In fact, only $1.6 billion in MBSs was publicly placed by private issuers over that period. 17/ Although private issuers can also privately place the MBSs they issue--that is, sell the securities outside the market bidding process--only an additional $2.2 to $2.8 billion in MBSs was privately placed as of June 30, 1982, according to available data. 18/

Changes in the Forms of Mortgage Credit

The forms of mortgage credit instruments have changed substantially in the last five years.

Although depository institutions now offer several different instruments to better match the rates on their short-term deposit account liabilities and their long-term mortgage assets, comprehensive data on the use of various forms of mortgage credit are not available. Data from a FHLBB sample

---

17. The Federal Home Loan Mortgage Corporation, The Secondary Market in Residential Mortgages, Publication No. 67, revised June 1982, p. 30.

18. Lepercq, de Neuflize and Co., Summary of Mortgage-Backed Securities Issued (outstanding as of June 30, 1982).

TABLE 4. OUTSTANDING FEDERALLY UNDERWRITTEN MORTGAGE-BACKED SECURITIES, 1970-1982 [a]

End of Period	Securities Outstanding (Billions of Dollars) Issued and/or Guaranteed By				Total as Percent of Outstanding Residential Mortgage Debt
	GNMA	FHLMC	FNMA	Total	
1970	0.4	---	---	0.4	0.1
1971	3.1	0.1	---	3.2	0.8
1972	5.5	0.4	---	5.9	1.3
1973	7.9	0.8	---	8.7	1.7
1974	11.8	0.8	---	12.6	2.3
1975	18.3	1.6	---	19.9	3.4
1976	30.6	2.7	---	33.3	5.1
1977	44.9	6.6	---	51.5	6.7
1978	54.4	11.9	---	66.3	7.5
1979	76.4	15.2	---	91.6	9.1
1980	93.9	16.9	---	110.8	10.0
1981	105.8	19.8	0.7	126.3	10.9
1982	119.2	55.7[b]	14.5[b]	189.4	15.1

SOURCE: Data from the Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), and the Board of Governors of the Federal Reserve System.

a. Includes both securities backed by loans on one- to four-unit homes and securities backed by mortgages on multifamily properties. In 1982, one- to four-unit loans backed 97 percent of the securities guaranteed by the GNMA, 84 percent of the securities issued by the FHLMC, and 100 percent of the securities issued by the FNMA. Data on the share of mortgages backed by single-family loans are not available for the GNMA and the FHLMC prior to 1974. Table excludes securities issued by the Farmers Home Administration. Those securities take the form of borrowing from the Treasury and are used to finance direct subsidized loans for low- and moderate-income housing.

b. Includes mortgage-backed securities traded under the swap programs of the FNMA and the FHLMC.

survey of lending activity compiled monthly since January 1981 are illustrative of the trend, however. 19/ Between January 1981 and January 1983, alternative mortgage instruments increased from 1 percent to an estimated 36 percent of all newly originated loans.

Once issued, these alternative mortgages are generally intended for sale to the FNMA, to the FHLMC, or directly to private investors or financial institutions to increase the supply of funds for additional loans. The FNMA, in particular, has become a major purchaser of adjustable rate mortgages, as reflected by the increased volume of their purchases from $107 million during 1981 to $3.2 billion in 1982. Both the FNMA and the FHLMC have also contributed to the development of alternative mortgage instruments through their willingness to purchase a variety of different kinds of adjustable rate loans.

Changes in the Cost of Mortgage Credit

Finally, the nominal and inflation-adjusted costs of mortgage credit have changed appreciably in the past decade, along with general economic conditions. Changes in federal policy during the last few years alone may also alter the cost of mortgage credit in the future relative to other forms of borrowing.

Although the sharp rise in inflation during the 1970s and early 1980s was reflected in rises in nominal interest rates, the same increase in inflation--and the relative isolation of mortgage lending institutions from the full effect of interest-rate fluctuations in the cost of their funds--often resulted in low, or even negative, interest costs net of inflation for homebuyers. In 1970, for example, interest rates on fixed-rate 30-year mortgages averaged 8.4 percent, while inflation (as measured by the broad-based gross national product deflator) was 5.4 percent. By 1978--the year in which deregulation of financial institutions began--the average mortgage interest rate had reached 9.6 percent, while the inflation rate had risen to 7.4 percent, resulting in a higher nominal mortgage interest rate but a lower

---

19. In this survey, alternative mortgages are all fully amortized mortgages with variable rates or payment schedules (e.g., graduated payment, growing equity, and variable rate mortgages). Mortgages that modify other features of the instrument--such as reverse annuity mortgages or shared appreciation mortgages--are also included. Balloon payment mortgages and mortgages involving negative amortization (i.e., accrual of unpaid interest, which is paid off over time by adjusting the total loan amount) are not included. See Appendix C.

interest rate net of inflation. During the next three years, as the cost of funds to lending institutions climbed, nominal mortgage interest rates, as well as interest rates net of inflation, rose steeply. From 1979 through 1981, average mortgage interest rates increased from just under 11 percent to nearly 15 percent, while inflation, as measured by the GNP deflator, averaged about 9 percent. Since 1982, as inflation has abated, mortgage interest rates have also declined, although they remain very high in comparison to current inflation rates.

Although it is too early to assess the net effect of the deregulation of financial institutions on mortgage interest rates, there is reason to believe that as the housing credit sector becomes more fully integrated into the broader credit market mortgage interest rates will move more closely with other interest rates, reflecting the market-rate cost of funds to lenders. First, because deregulation will make depository institutions--the major source for mortgage loan originations--better able to compete for deposits during periods of high interest rates, the supply of mortgage funds may be less volatile in the future. Second, the increased reliance on the secondary mortgage market may contribute to a steadier supply of mortgage capital by increasing access to a greater number of sources of funds.

CHAPTER V. POLICY OPTIONS

The changes in the operation of the housing finance system described in the preceding chapter raise issues as to what the role of the federal government ought to be in the future. Are further measures necessary to increase the efficiency of mortgage markets? Should changes be made in the present system of federal housing subsidies either to make homeownership more affordable or to reallocate credit between housing and other sectors of the economy?

This chapter first examines proposals that have been made to increase the efficiency of mortgage markets, and then considers options for altering present subsidies for housing through changes in federal tax provisions. Several of the options considered here are included in legislation now pending before the Congress.

INCREASING MARKET EFFICIENCY

Proposals intended to increase the efficiency of the housing credit sector are of three quite different sorts, reflecting different views about the net impact of current federal housing credit programs.

One set of options would expand federal mortgage insurance or secondary market programs in certain subsectors of the housing market. These options are premised on the view that such programs promote the efficient operation of housing credit markets by reducing risks for mortgage lenders and by lowering transaction costs for secondary-market investors. An argument against them is that they may divert the flow of capital from other sectors of the economy. Also, in some instances federally sponsored activity may limit the development of private-sector alternatives.

Other proposals would change federal tax or regulatory policies to remove what are considered to be impediments to the development of greater private-sector secondary market activity. Specifically, these options are intended to facilitate the development and marketing of privately issued securities backed by mortgages that are neither insured nor guaranteed by the federal government. They would eliminate statutory or regulatory provisions that treat such securities on less advantageous terms than their nonhousing alternatives. Doing so could improve the efficiency of credit markets by eliminating provisions that decrease the relative return on housing investments. These options could be considered either as alternatives or supplements to the first set of options.

A third set of proposals would take a very different approach--reducing the role of federal credit entities, or diminishing their ties to the federal government, in the view that their operations impede the development of private alternatives. Proponents of these options contend that the availability of federally provided mortgage insurance and the activities of federally supported secondary-market credit entities limit private-sector alternatives. It is possible, however, that the risks associated with such activities would continue to constrain the development of private alternatives even if the federal government withdrew. Nor is it certain that private alternatives could generate efficiencies that would lower interest rates more than the federal programs. In any event, in contrast to the first two sets of options, proposals of this sort would carry substantial risks for the housing finance system if private institutions did not move in rapidly to assume the vacated federal role.

Although all of the options discussed here would alter the federal role in the housing finance system--and the first set would selectively increase federal activity--none of them would involve returning to the earlier policy of heavily regulating primary market mortgage lenders. In addition, while some actions might improve the efficiency of the housing finance system, housing would remain a highly cyclical sector of the economy since it is necessarily sensitive to interest rate fluctuations.

Expanding Direct Federal Housing Credit Activity

Options for selectively increasing federal activity in the mortgage credit market include:

- Making additional alternative mortgage instruments eligible for federal insurance and guarantees; and
- Expanding secondary markets in existing instruments.

These options, which would make incremental changes in existing programs, are intended to improve the efficiency of the mortgage credit market by absorbing some of the risk borne by lenders and by facilitating transactions in the secondary mortgage market. In several instances, these changes would adjust for the unintended consequences of federal policies and statutes that have failed to keep up with the development of new mortgage instruments. However, to the extent that private alternatives have already developed to fill these gaps, expanding the federal role could supplant private activity now under way.

Making Additional Alternative Mortgage Instruments Eligible for Federal Insurance and Guarantees. The federal government might make more types of alternative mortgage instruments eligible for FHA insurance and VA guarantees, and therefore eligible for inclusion in pools to back GNMA-guaranteed MBSs. Currently, the FHA and the VA may insure or guarantee only fixed-rate mortgages or instruments involving prescheduled payment adjustments, such as graduated payment mortgages and growing equity mortgages. Expanding FHA and VA programs to cover more types of mortgage instruments--such as adjustable rate mortgages, reverse annuity mortgages, and shared appreciation mortgages--could increase government-backed lending. 1/ On the other hand, this change could increase federal expenditures from insurance and guarantee funds if the different types of mortgages proved riskier and had higher default/foreclosure rates than those currently insured. While these expenses could be offset through higher premiums on the alternative instruments, data on the relative riskiness of adjustable rate mortgages that would be needed to set premiums are not available.

Expanding the Secondary Markets in Existing Instruments. The federal government might also expand secondary markets for existing mortgage instruments, such as loans on manufactured housing, cooperative housing loans, second mortgages, mortgages insured by state housing finance agencies, and mortgages on expensive dwellings. Secondary market trading of these instruments, although important for some submarkets, would probably yield only small increases in overall mortgage funds.

--Expanding the secondary market in manufactured housing loans. The Congress could amend the FHLMC Charter Act to authorize the purchase of loans on manufactured housing and their use to back MBSs. 2/ Although the existing secondary market for manufactured housing loans is small, manufactured homes provide an affordable alternative to site-built housing for low- and moderate-income households. Additional mortgage credit for

---

1. S. 1338--reported by the Senate Committee on Banking, Housing and Urban Affairs on May 23, 1983, and amended by the Senate on June 21, 1983--would authorize FHA insurance for adjustable rate mortgages and shared appreciation mortgages, and, on a demonstration basis, for home equity conversion mortgages (one type of reverse annuity mortgage) for elderly homeowners. H.R. 1, as passed by the House of Representatives, would expand FHA authority to insure additional types of graduated payment mortgages.

2. These are loans secured in whole or in part by manufactured housing acquired as personal rather than commercial property.

manufactured homes could assist these households in becoming homeowners. 3/ On the other hand, the fact that many manufactured housing units are financed through retail installment credit contracts, rather than by standard mortgage loan instruments, suggests that these loans may be riskier than mortgages on site-built homes. If so, the FHLMC could incur losses by developing a manufactured housing loan purchase program without establishing adequate standardization rules for these instruments. 4/

--Expanding the secondary market in cooperative housing loans. Federal legislation could expand the secondary market in cooperative housing share and blanket loans by taking steps to help standardize these highly variable instruments. 5/ Standardization could be promoted by specifying criteria--such as minimum loan amounts and project characteristics--for loans that would be favored for resale to the FNMA or the FHLMC. Because cooperative housing loans constitute a sizable proportion of all mortgage loans only in a limited number of markets--including New York City, Chicago, and Washington, D.C.--standardization of these localized loans might be a prerequisite if a national secondary market were to develop.

--Expanding the secondary market in second mortgages. The federal government could also facilitate the flow of funds to housing through the secondary market by authorizing the purchase of all types of second mortgage loans and mortgage participations by the FHLMC. Currently, although the FNMA has fairly broad authority to deal in second mortgages, the FHLMC is limited to making transactions only in second mortgage loans

---

3. GNMA-guaranted securities backed by pools of manufactured home loans--primarily insured by the FHA under Title I of the National Housing Act of 1934, or guaranteed by the VA--currently sell well to institutional investors at yields close to the yields on GNMA-guaranteed securities backed by pools of single-family home loans.

4. H.R. 1, as passed by the House of Representatives, would authorize the FHLMC to purchase loans on manufactured homes. S. 1821, reported by the Senate Banking, Housing, and Urban Affairs Committee on October 6, 1983, would authorize the FHLMC to purchase loans on personal property manufactured homes.

5. Cooperative housing share loans are loans made to purchasers of individual cooperative units to finance a proportionate share of total project costs. A cooperative blanket loan is the single loan acquired either to build a cooperative project or to convert a project to cooperative units.

for energy and home improvement purposes. [6] Broadening the authority of the FHLMC in this area would provide another source for the purchase of such loans and for the issuance of MBSs backed by them. This could be especially important because the increased use of seller financing and other "creative" financing techniques in recent years has greatly increased the volume of second mortgage loans made--reaching an estimated $17 billion to $19 billion in 1982 alone. [7]

While this change could augment the amount of housing credit available through the federally sponsored credit agencies, it would involve some risk. Specifically, because of noncomparability among second mortgages and between second mortgages and first mortgages, the process of pooling them could pose problems, and the liability exposure of issuers could make the price unacceptable to investors. A system might therefore be needed to provide more complete information on the risks associated with second mortgages. Although potentially costly and time-consuming to develop, such information could protect the federally sponsored credit agencies and the investors in second mortgage loans.

--Expanding the secondary market in loans insured by state housing finance agencies. The Congress could amend the FHLMC Charter Act to authorize the purchase of conventional mortgages insured by state housing finance agencies. [8] Such a change could provide secondary market support for the state agency mortgage insurance programs which, in some instances, provide coverage for low- and moderate-income homebuyers unable to obtain private mortgage insurance. On the other hand, only five state agencies have mortgage insurance programs, and one of these agencies (in California) has yet to issue any insurance. 9/ Because the volume of mortgages insured by the other state agencies would probably be small, such a purchase program, though potentially significant in those states, would likely have little impact on the overall market for housing credit.

---

[6] H.R. 1, as passed by the House of Representatives, would expand the authority of the FHLMC to include transactions in all types of second mortgage loans on one- to four-unit homes and would state explicitly the authority of the FNMA to deal in conventional second mortgage loans--without the HUD regulations required for new programs. S. 1821, as reported by the Senate Banking, Housing, and Urban Affairs Committee, would put the FNMA and the FHLMC on equal footing by authorizing both corporations to purchase second mortgages for home purchase or improvement.

[7] Advance Mortgage Corporation, U.S. Housing Markets, October 22, 1982.

[8] H.R. 1, as passed by the House of Representatives, would authorize the FHLMC to purchase state agency-insured mortgage loans. S. 1821, as reported by the Senate Banking, Housing, and Urban Affairs Committee, would include state agency-insured mortgage loans among those conventional loans eligible for purchase by the FHLMC.

--Increasing the maximum size of loans eligible for FNMA and FHLMC purchase programs. The Congress could increase the number of loans eligible for FNMA and FHLMC purchase programs by amending the charter acts of these organizations to raise the current $108,300 ceiling on the value of individual mortgage loans purchased. 10/ Specific options include: raising the ceiling to a new absolute-dollar level, lifting the ceiling only in high-cost areas, allowing the FNMA and the FHLMC to purchase a certain percentage of mortgages valued above the current ceiling, or eliminating the ceiling entirely.

The effects of increasing the maximum loan size in FNMA and FHLMC purchase programs would vary according to the means chosen and the costliness of housing in a given market area. Raising the ceiling to a new absolute-dollar amount would expand access to FNMA and FHLMC programs in all areas with sizable shares of their housing stock selling for well above the present limits but would still leave access limited in the highest-cost markets. Lifting the ceiling only in high-cost areas would leave the top end of the market less well served in other areas but would result in a more equitable treatment across markets. Allowing the FNMA and the FHLMC to make a certain percentage of their mortgage purchases above the present limits would give those credit agencies discretion in determining what areas to serve, with the impacts less predictable.

On the other hand, any increase in the present ceiling would place the FNMA and the FHLMC in competition with private-sector credit entities such as the Residential Funding Corporation (RFC), recently established to provide a secondary market for large mortgage loans. 11/ Eliminating the

---

9. The other housing finance agencies with mortgage insurance programs are in Maryland, Vermont, New York, and Puerto Rico.

10. H.R. 3420, introduced in the House of Representatives on June 27, 1983, would raise the maximum purchase price limitations in high-cost areas for the FHLMC and the FNMA purchase programs to equal those established for the FHA Section 203(b) mortgage insurance program.

11. The RFC, a subsidiary of Norwest Mortgage, Inc., sells mortgages underwritten by the Mortgage Guaranty Insurance Corporation (MGIC)

ceiling might result in the FNMA and the FHLMC completely displacing the private-sector credit entities from the secondary market for large mortgage loans because of the relative advantage the federally sponsored credit agencies would have in their scale of operation and in the favored market status of their securities.

Encouraging Housing Credit Activity by the Private Sector

A second set of options would alter federal tax or regulatory policies to encourage the development and marketing of privately issued conventional mortgage-backed securities--that is, securities backed by mortgages neither insured by the FHA, nor guaranteed by the VA or the FmHA. Active trading in such securities could expand substantially the sources of funds for mortgage loans, if pension plans and other investors (such as life insurance companies and real estate investment trusts) became major purchasers of these instruments using funds they would not otherwise have invested in housing. Such privately issued securities have been slow to develop, however. Since 1977, when the first major private, conventional MBSs were issued by the Bank of America and by the First Federal Savings and Loan Association of Chicago, fewer than 50 private institutions have issued mortgage-backed securities. As of June 1982, available data on both publicly and privately placed issues indicate that only $4.4 billion in privately issued conventional MBSs were outstanding. 12/

Many factors have been cited as impediments to the development of an active secondary market in privately issued conventional MBSs, including regulations of the Federal Reserve System, the Securities and Exchange Commission, the Department of Labor, and the Internal Revenue Service, all of which have been criticized as adding to the costs of potential issuers of private MBSs. These regulations are often historical accidents of policy

---

11. (Continued)
to investors through the Salomon Brothers Co. The types of mortgage loans purchased by the RFC include: 15-year loans valued up to $500,000; wraparound mortgages; growing equity mortgages; graduated payment mortgages with buydowns; adjustable rate mortgages, including those with investor borrowers; and 30-year fixed rate mortgages with down payments of at least 5 percent.

12. Lepercq, de Neuflize and Co., Summary of Mortgage-Backed Securities Issued (Outstanding as of June 30, 1982).

that reflect the fact that private MBSs did not exist when the regulations were first established. Therefore MBSs are not covered by them in a systematic way. 13/

Although several of the perceived impediments to active trading in such instruments have been removed recently, others remain. 14/ Options for reducing remaining barriers to the development of an active market in privately issued conventional MBSs include:

- Standardizing privately issued conventional MBSs and improving information regarding the riskiness of individual issues;
- Amending the federal tax code to remove disadvantages now borne by privately issued conventional MBSs; and
- Further modifying ERISA regulations to encourage pension fund investment in these securities. 15/

---

13. See The Report of the President's Commission on Housing (1982), p. 145, for further discussion of these policy accidents.

14. The Federal Reserve System now allows privately issued conventional mortgage-backed securities with certain characteristics to be traded over-the-counter (i.e., without registration) using margin loans at brokerage firms. Regulation T previously provided this privilege only to corporate obligations. Its extension to cover conventional privately issued MBSs requires: an original issue of $25 million, current filings with the Securities and Exchange Commission, and the passing through of mortgage interest and principal payments by the agent according to the terms of the offering. In addition, the Securities and Exchange Commission has eliminated the 30- to 60-day filing delay often encountered in registering and therefore marketing all securities. Recent rulings by the Department of Labor on eligible investments for pension plans covered by the Employee Retirement Income Security Act (ERISA) regulations have also removed some barriers to investment in privately issued conventional MBSs. See 47 FR 43070, 47 FR 55912, and 47 FR 39799.

15. S. 1821, as reported by the Senate Banking, Housing, and Urban Affairs Committee, would take several other actions to remove impediments to active trading in privately issued MBSs by: broadening the exemption from security registration requirements; preempting state registration and investment requirements; and extending SEC shelf

Even if all these actions were taken, however, it is unclear whether or how quickly a secondary market in privately issued conventional MBSs would supplant the existing federally supported one. For one thing, concerns about the safety of the underlying mortgages or the possibility of prepayment may continue to make these securities less attractive than nonhousing securities. 16/ Also, as long as federally supported MBSs exist, investors may continue to view privately issued conventional securities as less desirable investments because they are not issued by an entity with ties to the federal government. If the interest-rate differential required to attract investors to the riskier instruments could not be supported by the rates paid on the underlying mortgages, the private market would not expand.

Standardizing Privately Issued Conventional MBSs and Improving Information Regarding their Riskiness. Some view the lack of uniformity in the underlying conventional mortgages and the lack of information about their quality to be impediments to the development of a market for privately issued conventional MBSs.

The federal government could help standardize these securities through regulations by the FHLBB or the Comptroller of the Currency establishing criteria--such as limits on the loan-to-value ratio, the maximum dollar value, and the age and form of the underlying mortgages--for mortgages placed in pools to back these MBSs. Standardization could also include a requirement that a reserve fund be maintained to help ensure timely payments on the security, if cash flow from the pool proves insufficient. 17/ Requiring a reserve fund could increase investor confidence that principal and interest payments would be made but could also lessen the net return to investors. The size of such a reserve and the rate of

---

15. (Continued)
registration (i.e., an abbreviated and time-saving registration process that can be used when disclosure materials remain unchanged for several MBS issues) beyond its 1983 expiration.

16. All types of MBSs have a different term structure from--and are marketed at a disadvantage to--nonhousing securities, because of the scheduled amortization payments on their underlying investment and the possibility of prepayment of the individual mortgages in a pool.

17. See The Report of the President's Commission on Housing (1982), p. 148. Depending on the use intended for privately issued conventional MBSs, the requirement of a reserve fund could necessitate the issuance of regulations by the FHLBB, the Department of Labor, or the Securities and Exchange Commission.

return realized on it would be crucial to the profitability and, hence, the competitiveness of these instruments. In addition, too much standardization could limit innovation in the forms of mortgages that might otherwise occur in times of high interest rates and inflation.

Information on MBSs could be improved by establishing a service to rate securities according to the riskiness of the underlying mortgages and the issuer's past performance. Because such a rating service would increase the available information about the quality of privately issued conventional MBSs, it could increase investments in these securities. On the other hand, establishing and operating a rating service would not be without cost. If the costs of such a service was borne by the federal government, it would add to the budget deficit. If, instead, the service was funded out of fees paid by issuers or buyers of the securities, the expense would lessen the net yield on the MBSs but could also reduce their riskiness.

Amending the Federal Tax Code. The federal tax code may also constrain the development of a secondary market in privately issued MBSs by taxing these securities' proceeds at both the certificate holder and asset pool levels. Although income from regulated investment companies (e.g., mutual funds) which issue the securities most competitive with MBSs is taxed only at the shareholder level, issuers of actively managed MBSs can be taxed at the pool level, even if all net income is passed through to the certificate holders. To avoid double taxation, most MBS portfolios are managed passively through the inflexible grantor trust device. This device restricts the substitution of loans, the reinvestment of principal payments, the use of investment contracts to insure anticipated yields, and the use of delayed delivery mortgages. These restrictions reduce profitability and, if removed, could provide greater certainty of cash flow and protection for the investor from the call of a mortgage upon prepayment and thus the loss of its value from the security.

Making privately issued conventional MBSs eligible for the same tax treatment as securities issued by regulated investment companies could increase the profitability of the instrument and, thus, the number of such instruments issued. On the other hand, making MBSs eligible for taxation only at the shareholder level without the constraints of the grantor trust management mechanism would increase trading in privately issued conventional MBSs only if investment brokers and managers became convinced that MBSs issued under the more favorable tax code would be as marketable as other securities. Also, to the extent that such a change increased the overall flow of capital to housing, it would divert investments into a sector of the economy that already enjoys many advantages through the federal tax system, unless these are modified.

Trusts for Investments in Mortgages (TIMs)--an idea that grew out of the recent President's Commission on Housing--would amend the tax code and provide additional regulations to increase the flexibility for issuing MBSs. [18] Under the TIMs provisions, the MBS would be a security interest in a form of business trust to be organized by any mortgage market participant with the minimum required assets. All types of mortgages would be eligible for pooling to back securities under the TIMs proposal, including first and second mortgages on single-family units, condominiums, cooperatives, and rental projects. Conventional, FHA-insured, VA-guaranteed, FmHA-guaranteed, plus a variety of alternative mortgage instruments would be eligible for MBS pools under the TIMs regulations. Because the assets and income from MBSs issued under the TIMs provisions would come from residential mortgage loans, the instrument might be an attractive investment for savings and loan associations, state housing finance agencies, and pension plans.

The TIMs provisions would authorize the issuance of MBSs with characteristics that could give them a competitive advantage over present MBSs. Proposed TIMs provisions would eliminate the need for individual rulings by the Internal Revenue Service to exempt MBSs from the requirements of the grantor trust mechanism and would have distributions from the MBSs taxed at the investor level only. Protection of the investor from the removal (or call) of a prepaid mortgage from the pool backing the MBS could be provided by allowing issuers to hold back and reinvest any portion of a monthly payment to be distributed to investors at a later date. Payments also could be made less frequently than monthly to appeal to a broader group of investors than MBSs currently do. The marketing of securities prior to the delivery of their underlying mortgages could be allowed under the TIMs provisions as well.

Although the proposed TIMs provisions would eliminate the restrictions associated with the grantor trust management mechanism, the same advantages as offering MBSs without this form of management could be achieved directly if the Treasury would expand the reinvestment latitude and other characteristics of this trust mechanism. If the Treasury were to redefine the terms of the grantor trust management mechanism, a more flexible MBS could be offered with perhaps greater simplicity than would be involved in establishing the TIMs provisions by statute.

---

18. S. 1822, introduced in the Senate during the first session of the 98th Congress, would amend the tax code to encourage investment in MBSs through trusts for investments in mortgages (TIMs) but would preclude the FNMA and the FHLMC from being trustees, directors, or shareholders for these securities.

Liberal issuing requirements for MBSs under the TIMs proposal--whether achieved by statute or regulation--might, however, attract small issuers into an investment activity for which they are not adequately prepared. If small mortgage brokers marketed MBSs that generated sizable losses for their investors, the TIMs provisions--by bad example--could impede expansion of a secondary market in privately issued conventional MBSs. This risk could be reduced by requiring issuers of MBSs to maintain a reserve equal to some percentage of the outstanding principal balance of the mortgages in the pool.

Further Modifying ERISA Regulations. Another means of encouraging the issuance and trading of private conventional MBSs would be to modify further ERISA regulations to promote the purchase of these securities by pension plans. Pension plan investment in mortgages and MBSs could match a source of long-term investment cash with a demand for long-term credit, contributing to the overall efficiency of credit markets. Pension plans had assets of $600 billion--roughly equivalent to that of the savings and loan industry--in the early 1980s, and plan assets are projected to grow to over $1 trillion by the middle of the decade. 19/ While some state and local employee pension plans include MBSs in their portfolios, private pension plans generally do not. 20/

Although ERISA regulations have been amended twice since the beginning of 1982 to encourage pension plan investment in mortgages and MBSs, plan investment in privately issued conventional MBSs is still on less

---

19. Barbara L. Miles, "The Government National Mortgage Association Mortgage-Backed Securities Program: Proposed Limitations on the Use of 'Ginnie Maes'," Congressional Research Service, Library of Congress (June 29, 1982), p. 9.

20. The limited amount of private pension plan investment in mortgages has been attributed to many factors, including greater familiarity of plan investment managers with bonds than MBSs; investment prohibitions in the Employee Retirement Income Security Act (ERISA) regulations; and the unusual and uncertain cash flow patterns of securities due to the prepayment of mortgages in the pools. Some of the reasons for public pension plan investment in conventional MBSs include receptivity of their in-house managers to mortgage investments, the size of these plans, and their willingness to make timely decisions. Exemption of public plans from ERISA regulations, and a political motivation toward local or in-state investment, are also cited as reasons for this investment.

advantageous terms than investment in MBSs issued or guaranteed by the federal secondary market credit entities. In short, while the security--rather than its underlying mortgages--is evaluated to be a plan asset for FNMA and FHLMC MBSs and for GNMA-guaranteed MBSs, in the case of privately issued conventional MBSs, the underlying mortgages are evaluated to be plan assets. Because each conventional mortgage in a pool must be acceptable as a pension plan asset, there is a greater likelihood that a plan will reject for investment a security backed by conventional mortgages.

The federal government could encourage pension plan investments in privately issued conventional MBSs by amending ERISA regulations to treat those securities and the federally issued or guaranteed MBSs alike. Such a change--which would not require a change in law--might go a long way toward promoting a test of the viability of the secondary market in privately issued conventional MBSs. Increased trading of these securities could, in turn, encourage the development of a futures market in them. A futures market in privately issued conventional MBSs would reduce the interest rate risk and uncertainty associated with the security by guaranteeing its future rate. It could thus enhance the competitiveness of the instruments with GNMA-guaranteed MBSs--which have futures markets on both the Chicago Board of Trade and the Amex Commodity Exchange.

On the other hand, amending ERISA regulations to allow pension plan investment in privately issued conventional MBSs and federally issued and guaranteed MBSs on the same terms might diminish control over the quality of these investments. If investments in conventional mortgages and in privately issued MBSs backed by them turned out to be riskier than investments in federally insured or guaranteed mortgages and federally issued or guaranteed MBSs, pension plans might experience greater losses and thus lower net returns on their funds.

Reducing Direct Federal Housing Credit Activity

A third set of options would reduce the direct federal role in the housing finance system with the hope of stimulating greater private activity. Specific alternatives include:

- Limiting or refocusing federal mortgage insurance;
- Reducing GNMA activity or removing the favored status of GNMA securities; and
- Reorganizing the Federal Home Loan Mortgage Corporation by reducing its direct tie to the federal government.

The first two options would curtail the direct federal role in the housing finance system. The third option--reorganizing the FHLMC--would move into the private sector an institution that now operates within the public domain.

All of these options are based on the belief that federally supported mortgage credit activity impedes the development of private-sector alternatives which, if they existed, would generate efficiencies that would lower interest rates more than the publicly sponsored ones they would supplant. Whether such private alternatives would develop rapidly to fill a void left by federal withdrawal is uncertain, however; nor is it certain that the private-sector alternatives would be more efficient. Furthermore, if private alternatives did not develop quickly, appreciably reducing the federal role could cause dislocations for the housing finance system. The risks of such dislocations could be lessened, but not eliminated, if federal credit activity was reduced only gradually or in selective areas where it overlaps most with private activity.

Limiting or Refocusing Federal Mortgage Insurance. The government could reduce federal mortgage insurance activity by lowering the volume of loan insurance commitments the FHA is authorized to make annually, by refocusing the program on groups of borrowers less likely to be served by private insurers, or by establishing reinsurance contracts with private mortgage insurance companies.

The Congress could limit the mortgage insurance programs of the FHA directly by reducing the annual authorization for new insurance. The Administration recommended sharply reduced commitment levels for both fiscal years 1983 and 1984, but in neither case has the Congress adopted the reduced levels. For fiscal year 1983, the Administration originally recommended a limitation on new insurance commitments of $35 billion, but the Congress initially set the limit at $45.9 billion and later increased it to $50.9 billion in an act providing supplemental appropriations for fiscal year 1983. For fiscal year 1984, the Administration recommended a limitation of $39.8 billion in its January 1983 budget submission, but the Congress has again set the limit on new FHA insurance commitments at $50.9 billion. If in the future the Congress reduced markedly the volume of new FHA insurance, the impacts on potential homebuyers would depend on how the remaining insurance was rationed--specifically, on whether it was made available to those borrowers least likely to be served by private insurers.

The Congress also could lessen the volume of new FHA insurance by increasing premiums. Annual premiums are currently 0.5 percent of the unpaid principal value, and premium collection as a lump-sum-payment--equivalent to 3.8 percent of the total value of a 30-year level payment mortgage--at the time of settlement was authorized in the Omnibus Budget Reconciliation Act of 1982. If the premium rate was increased uniformly, low-income borrowers might be excluded from the mortgage insurance program because of its cost. In addition, with higher premiums, FHA insurance could become noncompetitive with insurance provided by private issuers. 21/ On the other hand, even at higher premiums, FHA insurance could retain an advantage over private mortgage insurance because FHA-insured loans are eligible for packaging in securities guaranteed by the GNMA.

Alternatively, FHA mortgage insurance programs could be limited by explicitly targeting them on certain groups of borrowers. For example, federal mortgage insurance could be focused on the higher-risk borrowers less likely to be served by the private sector. 22/ Limiting FHA insurance in this manner would continue service to those most in need, but could also raise federal costs, since default rates would probably increase. Furthermore, because FHA insurance is already targeted on underserved populations, any further targeting could eliminate households who would not be acceptable to private insurers. 23/

---

21. The FHA charges all borrowers a flat fee of 0.5 percent of the loan value. Private mortgage insurers in their annual premium plans, on the other hand, vary the percentage of the outstanding loan value charged as the premium by the year of the mortgage term, by the percentage of the loan insured, and by the loan-to-value ratio. For example, the first-year premium on a mortgage with a loan-to-value ratio of 86 to 90 percent--of which 20 percent is insured--would be 0.5 percent. The premium on this loan in all subsequent years would be 0.25 percent. On the other hand, the premium on a mortgage loan insured for 10 percent of its value and with a loan-to-value ratio of 80 percent or less, would be 0.125 percent of the outstanding loan value throughout its term.

22. The loan-to-value ratio is one conventionally accepted measure of loan riskiness. In 1981, a greater percentage of the mortgages insured by private mortgage insurers than by the FHA had loan-to-value ratios below 90 percent.

23. See James Barth, Joseph Cordes, and Anthony Yezer, "Federal Government Attempts to Influence the Allocation of Mortgage Credit: FHA Mortgage Insurance and Government Regulations," in Congressional Budget Office, Conference on the Economics of Federal Credit Activity, Part II-Papers (September 1981), pp. 159-232.

Finally, the government could lessen federal mortgage insurance activity by authorizing reinsurance contracts with private mortgage insurance companies. During the first session of the 98th Congress, Senator Proxmire introduced S. 835, a bill that would authorize the FHA to establish reinsurance contracts requiring that private mortgage insurance companies assume a percentage of the loss on any of the mortgages insured under the largest FHA insurance programs and delegating to private insurers certain functions--such as credit approval, appraisal, inspection, commitment, claims processing, and property disposition. Any reinsurance contract would provide for the sharing of premiums and of necessary insurance reserves between the FHA and the private mortgage insurance companies.

Although requiring reinsurance contracts would share the risk between the government and private insurers, its eventual impact on federal expenses would depend on precisely how premiums and risks were shared. Also, requiring such contracts could either increase the cost of insurance or limit its availability for higher-risk homebuyers, if private mortgage insurers were unwilling to participate under current FHA terms.

Reducing GNMA Activity or Removing the Favored Status of GNMA Securities. Proposals to reduce GNMA activity or to remove the favored status of its securities are motivated by a concern that the GNMA MBS program may impede the development of private guarantee programs for MBSs. If, in fact, GNMA MBSs merely supplant private, nonguaranteed securities that would have been issued in any event, limiting GNMA activity could help stimulate the existing small market in MBSs neither issued nor guaranteed by federal secondary market credit entities. [24] As long as the current GNMA MBS program is in operation, however, it is impossible to know whether GNMA securities principally supplant other MBS issues or supplement the total volume of MBSs. Eliminating the GNMA MBS guarantee program entirely or reducing it sharply would allow one to examine its impact but could seriously disrupt secondary market activity if the GNMA guarantee proved essential to the issuance and trading of MBSs backed by FHA/VA/FmHA mortgages. Although less precipitous changes might enable information to be gathered about the responsiveness of the private market with fewer dangers, even gradual changes would not be without some risks. Furthermore, as private alternatives developed, they might prove less efficient than the publicly supported ones they would supplant.

---

[24] See David F. Seiders, "The GNMA-Guaranteed Passthrough Security: Market Development and Implications for the Growth and Stability of Home Mortgage Lending," Staff Study No. 108, Board of Governors of the Federal Reserve System (December 1979), p. 4; and Patric H. Hendershott and Kevin E. Villani, "Residential Mortgage Markets and the Cost of Mortgage Funds," American Real Estate and Urban Economics Association Journal, vol. 8, no. 1 (Spring 1980), p. 59.

Specific options for curtailing government activity include:

- Reducing GNMA guarantee activity across the board;
- Authorizing the guarantee only of securities backed by pools of innovative mortgages; and
- Eliminating the full-faith-and-credit GNMA guarantee.

--Reducing GNMA guarantee activity across the board. GNMA's guarantee activity could be reduced directly by cutting back the annually legislated ceiling on new MBS guarantees or indirectly, either by limiting the number of FHA/VA loans or by increasing fees on new GNMA guarantee commitments. 25/ Limiting GNMA's guarantee activity in any of these ways would lessen the contingent liability of the federal government for payment of principal and interest to investors in the guaranteed MBSs. It would not, however, reduce the government's contingent liability for the underlying mortgage debt unless it was accompanied by a reduction in the number of federally insured or guaranteed loans. 26/ The impact on near-term federal revenues would depend on how the amount of commitment and guarantee fees was affected.

However it was accomplished, there is a serious question whether a retrenchment in GNMA-guaranteed MBSs would be sufficient to encourage development of a secondary market in privately issued nonguaranteed or

---

25. Effective October 1, 1982, the GNMA initiated an issuer application fee and increased the commitment application fee for its MBS program. An issuer application fee of $250 is now required when any mortgage lending institution first seeks GNMA approval to become an issuer of MBSs. The former commitment application fee of $500 has been replaced by a sliding scale fee. For the first $1.5 million of commitment amounts the fee is $500, while an additional fee of $200 is charged for each $1 million (or part thereof) above $1.5 million.

26. In its January 1983 budget submission, the Administration recommended a $58.65 billion limit on GNMA commitments for guarantees of mortgage-backed securities for fiscal year 1984. The 1984 Department of HUD-Independent Agencies Appropriation Act established a ceiling of $68.25 billion.

privately guaranteed MBSs. Because regular payment of principal and interest on GNMA securities would still carry the full-faith-and-credit guarantee of the federal government, it might be difficult for nonguaranteed or privately guaranteed MBSs to compete with even a reduced volume of GNMA-guaranteed securities.

--Authorizing the guarantee only of securities backed by innovative mortgages. Another means of reducing the volume of GNMA-guaranteed MBSs would be to authorize the agency to guarantee only those securities backed by pools of innovative federally underwritten mortgages--that is, loans using other than fixed-rate long-term repayment schedules. If one reason for seeking FHA insurance, VA guarantees, or FmHA guarantees for mortgages is to make them eligible for guarantee by the GNMA, then limiting the GNMA guarantee to this smaller pool of mortgages could, for example, lessen the demand for FHA mortgage insurance and increase the share of mortgages insured by private companies. A GNMA guarantee program scaled back in this way could continue to encourage the development of innovative mortgages while providing information on both the investor acceptance of such loans and the pricing of new types of mortgage-backed securities for use by the private market. 27/ On the other hand, doing away with GNMA guarantees for noninnovative mortgages could reduce substantially the flow of funds to housing through the secondary market unless private activity expanded rapidly to fill the gap.

--Eliminating the full-faith-and-credit guarantee. A third way to reduce federal involvement in the secondary mortgage market would be to eliminate the full-faith-and-credit government guarantee currently enjoyed by GNMA MBSs and transfer the guarantee function to the FNMA or the FHLMC. 28/ In either event, because the guarantee no longer would be backed by the full faith and credit of the government, lenders would likely perceive it to be of less value. Thus, if lenders continue to make FHA-insured, VA-guaranteed, and FmHA-guaranteed loans with the intention of marketing them in guaranteed MBSs, they would probably seek to raise the

---

27. See The Report of the President's Commission on Housing (1982), p. 167.

28. The FHLMC interprets its charter as allowing it to guarantee MBSs issued by other institutions. S.1821, as reported by the Senate Banking, Housing, and Urban Affairs Committee, would prohibit the FHLMC from guaranteeing mortgage-related securities issued by others. In its legislative proposals presented at hearings before the Senate Subcommittee on Housing and Urban Affairs on May 5, 1983, the FNMA sought authority to guarantee MBSs issued by others.

interest rate on underlying loans, or, if that was not permissible, to increase the points charged in order to compensate for the reduced value of the guarantee on the MBSs.

If either the FNMA or the FHLMC assumed the guarantee function, the expected increase in interest rates or points on FHA-insured, VA-guaranteed, or FmHA-guaranteed mortgages would be limited to the value of the GNMA cash-flow guarantee relative to that of one of the federally sponsored credit agencies. 29/ Under any circumstances, eliminating the full-faith-and-credit GNMA guarantee would lessen only the federal government's contingent liability for the proceeds of the securities; it would not eliminate the government's contingent liability for the underlying mortgage debt. Eliminating the GNMA guarantee would also reduce federal receipts by ending commitment and guarantee fees.

Reorganizing the Federal Home Loan Mortgage Corporation. Another way of diminishing the direct federal role in the housing credit market would be to reorganize the FHLMC as a private institution to more nearly resemble the FNMA. Although diminishing the FHLMC's ties to the federal government could encourage the development of other private secondary market institutions, its net impact on housing credit markets would depend on the precise nature of the reorganization and how the restructured agency chose to operate--something which is difficult to forecast in advance. 30/

---

29. Both the MBS issues and the debentures of the FNMA and the FHLMC are already attractive to investors because: they are exempt from Securities and Exchange Commission requirements; they do not jeopardize the tax status of pension plans, insurance companies, or thrift institutions; they may be used as collateral by financial institutions for repurchase agreements or Federal Home Loan Bank or other borrowing; and they are exempt by regulation from the prohibited transactions rules governing pension funds under the Employee Retirement Income Security Act. See Barbara L. Miles, "The Government National Mortgage Association Mortgage-Backed Securities Program: Proposed Limitations on the Use of 'Ginnie Maes'," Congressional Research Service, Library of Congress (June 29, 1982), pp. 12-13.

30. See To Expand and Reorganize the Federal Home Loan Mortgage Corporation, Hearings before the Subcommittee on Housing and Community Development, Committee on Banking, Finance and Urban Affairs, House of Representatives, 97 Cong., 2 sess. (April 21 and June 3, 1982), p. 537.

During the 97th Congress, three bills--S. 1805, H.R. 4787, and H.R. 6442--were introduced which would have reorganized the FHLMC as a private taxpaying entity. Under these proposals, the private FHLMC would be precluded from borrowing from the Federal Home Loan Bank System, but the Federal Home Loan Banks would provide a $200 million emergency fund for the FHLMC. The FHLMC's securities would continue to be treated as they currently are under state investment laws, which ensure a broad market for them, and would continue to be considered eligible investments for federally supervised institutions. Because the Federal Home Loan Bank member institutions provided the initial $100 million to capitalize the FHLMC, the current stock of the FHLMC would be redistributed to the savings and loan associations, and the FHLMC would be authorized to recapitalize itself by selling stock to either the users of its program or the general public.

A private, taxpaying FHLMC could either lessen or increase the federal government's liability for mortgage debt, depending on the specifics of the reorganization and the operation of the newly private agency. Because the FHLMC would become a private institution, the federal government would have explicit responsibility for the mortgage debt the FHLMC acquired only up to the limit in the emergency fund. Thus, under the proposals made during the last Congress, the federal contingent liability would be lessened unless actual liabilities of the FHLMC ever were to exceed $200 million. On the other hand, if a private FHLMC acquired a sizable proportion of all conventional mortgages, the Congress might find it difficult to allow the institution to become insolvent. If that occurred, the federal government's effective liability could eventually increase.

A related question is whether, if the FHLMC was reorganized as a private institution with virtually the same operating authority as the FNMA, the two institutions should then be merged. Senator Tower, in introducing on August 4, 1983, legislation to alter some present federal secondary credit market programs, raised the broader issue of the future institutional forms of both the FHLMC and the FNMA. 31/ Among the specific options cited were merging a reorganized FHLMC with the FNMA, as well as leaving the FNMA intact while transfering ownership of the FHLMC to the private sector. If a merger of the two federal credit entities was undertaken, the impact on the housing credit market--and particularly on fully private competitors--would depend on what specific authorities were granted to the new agency and what ties it retained to the government. In any event, a FNMA-FHLMC merger might not be feasible unless attempted after the FNMA had experienced several quarters without reporting a loss. (For the

---

31. The Congressional Record, August 4, 1983, pp. S11779, S11782.

first quarter of 1983 the FNMA reported its first profit since the fourth quarter of 1980, and it continued to report a profit for the second and the third quarters of 1983.)

ALTERING FEDERAL SUBSIDIES

A second broad issue is whether to change the federal subsidies now provided for housing. This question arises out of two different--but not necessarily contradictory--concerns. On the one hand, homeownership has become increasingly difficult for low- and moderate-income households to finance, even with the existing subsidies provided through the tax system. At the same time, some believe that federal tax policies give greater incentives to investment in residential housing overall than is warranted in the present state of the economy, particularly in light of lagging productivity growth in other sectors of the economy.

The sections that follow describe two sets of options for altering housing subsidies. Both sets deal with federal tax provisions, the major source of present subsidies for housing. The first set of options would increase subsidies for persons who might otherwise find homeownership difficult to afford; the second set of options would curtail untargeted federal subsidies as a means of reducing the relative attractiveness of housing as an investment compared with other uses of capital. Options from either set could be pursued separately, or specific alternatives from both sets might be adopted simultaneously, with some or all of the increased federal revenues generated by the latter options used to help offset the revenue losses resulting from the former.

Increasing Targeted Subsidies

Targeted subsidies for particular groups of homebuyers could be increased by:

- Extending the use of tax-exempt revenue bonds for single-family mortgages beyond the currently scheduled December 31, 1983, expiration;

- Establishing a tax credit for mortgage interest payments by homebuyers; or

- Authorizing tax-subsidized savings accounts for home purchases.

The first two options would reduce after-tax interest costs for homebuyers. The third would assist them to accumulate the necessary down payment.

Extending the Use of Tax-Exempt Mortgage Revenue Bonds. One means of subsidizing mortgage credit would be to extend the availability of tax-exempt mortgage revenue bonds for single-family housing beyond the scheduled expiration on December 31, 1983. Specific alternatives include extending the current program or targeting the use of bonds more narrowly.

Regardless of the form of a mortgage revenue bond program, however, tax-exempt bonds are generally less efficient than direct subsidies--that is, a smaller proportion of the revenue loss is realized by the homebuyer than is the case for outlays under direct expenditure programs. A CBO analysis undertaken several years ago indicated that between 43 percent and 54 percent of the subsidy provided through tax-exempt mortgage revenue bonds went to the homebuyers. Most of the remainder went to bondholders and intermediaries, including issuers, underwriters, and bond counsel. In contrast, a now largely inactive direct mortgage assistance program for low- and moderate-income homebuyers (the Section 235 program) was 90 percent cost-efficient.

--Extending the current program. Extending the current program for tax-exempt mortgage revenue bonds would increase the future supply of below-market-interest rate mortgages for homebuyers. It would, however, result in increased revenue losses to the Treasury and could also increase borrowing costs to state and local governments for all purposes by driving up the interest paid on other tax-exempt bonds. Continuing the present program would provide an estimated $84 billion in additional reduced-interest mortgages over the 1984-1988 period and would result in an increased revenue loss of $2.8 billion during the corresponding five fiscal years. 32/

--Targeting the program more narrowly. Alternatively, the Congress could repeal the present "sunset" provision for tax-exempt mortgage revenue bonds for single-family homes, but target the use of bonds more narrowly. The current program targets aid on first-time homebuyers and, to a lesser degree, on areas designated as distressed on the basis of such factors as the condition of the housing stock in the area and the potential

---

32. This revenue loss is in addition to the $7.9 billion expected between 1984 and 1988 as a result of the $39.4 billion in bonds that will be outstanding on December 31, 1983. The difference of $2.8 billion understates the eventual revenue effect of continued use of the bonds, however, because it does not reflect the fact that the federal government will continue to sustain revenue losses for as long as the newly issued bonds are outstanding--up to 30 years in many cases.

for the use of owner financing to improve housing conditions. In addition, price limits on homes purchased with bond-assisted mortgages limit maximum benefits per household. There is evidence to suggest, however, that many of the households currently assisted might have been able to purchase homes without the assistance. In a recent study, the General Accounting Office found that borrowers with incomes above $20,000 received three-quarters of the mortgage loans, and borrowers with incomes above $35,000 received 15 percent of the mortgage loans provided from revenue bond proceeds. 33/

The present subsidy could be more narrowly targeted on low- and moderate-income households by placing income limits on households, by establishing mortgage-value ceilings, or by limiting the subsidy to households that forgo the deduction of mortgage interest from taxable income. 34/ Any such change would target assistance on those households most in need of financial aid to purchase homes but would not reduce the federal revenue loss unless it led to a reduction in the total volume of bonds issued--something that is now controlled principally by state-by-state limits.

Establishing a Tax Credit for Mortgage Interest Payments by Homeowners. Another means of increasing subsidies to housing credit for low- and moderate-income homebuyers would be to establish a partial tax credit against mortgage interest payments. Such a credit could extend the present mortgage interest tax subsidy to the many lower-income homeowners who do not benefit from the current interest deduction, because they take the standard deduction rather than itemize.

A tax credit for mortgage interest payments could be targeted on low- and moderate-income families either by restricting its use to families with incomes below specified limits or by requiring that families choose between

---

33. General Accounting Office, The Costs and Benefits of Single-Family Mortgage Revenue Bonds: Preliminary Report (April 1983), pp. 11, 14, 16-17.

34. Requiring that home purchasers choose between receiving a mortgage financed by a tax-exempt bond or deducting mortgage interest payments from taxable income would likely cause high-income households to exclude themselves from the bond program. The existing mortgage interest deduction would almost always save those households more in taxes than they would gain from the lower interest rates in the bond program. See Congressional Budget Office, Tax-Exempt Bonds for Single-Family Housing (April 1979), p. 95.

the credit and the present mortgage interest deduction. In either case, if a tax credit was established without altering present mortgage interest deductibility provisions, the credit would add to total federal revenue losses. Alternatively (as discussed below), the additional revenue loss resulting from a tax credit could be partially or fully offset by limiting mortgage interest deductibility. 35/ In any event, a tax credit is a more efficient subsidy mechanism than mortgage revenue bonds--that is, a greater share of the revenue loss would be realized by homebuyers as reductions in their net housing costs. Therefore, a larger number of households could be aided at the same total cost to the government.

Authorizing Tax-Subsidized Savings Accounts for Home Purchases. Taking a different approach, the Congress could assist first-time homebuyers to accumulate funds for down payments by authorizing tax-subsidized savings accounts, known as individual housing accounts (IHAs). 36/ These accounts, similar to individual retirement accounts, would permit prospective homeowners to deposit up to a maximum amount each year and in total into a savings account whose balance could be used as a down payment on a home. Annual contributions to the accounts either would be tax-deductible or would qualify for tax credits, while interest earnings would be tax-free. If funds were withdrawn from these accounts and used for other than their intended purpose, a penalty would be assessed against the account holder.

Tax-subsidized housing savings accounts would enable prospective buyers to accumulate down payments more quickly than otherwise would be possible, to purchase homes of increased value, or to increase the size of their down payments--thereby reducing monthly payments throughout the mortgage term. Such accounts would probably benefit higher-income households--with greater saving potential--more than less affluent ones.

---

35. H.R. 3594 and S. 1598, introduced during the first session of the 98th Congress, would provide limited tax credits for mortgage interest payments in states or localities that elect not to use mortgage revenue bonds.

36. Several forms of individual housing accounts have been proposed in bills introduced during the first session of the 98th Congress. Two bills--H.R. 2916 and S. 1435--would establish accounts similar to individual retirement accounts to facilitate the accumulation of down payment funds for the purchase of a principal residence. Other bills--H.R. 2567 and S. 1051, for example--would also permit homeowners to prepay more rapidly mortgages on houses acquired before the accounts were established.

Providing a tax credit rather than deductibility for contributions to these accounts would target aid more narrowly on households most in need of assistance.

Reducing Overall Subsidies

In addition to--or independent of--increasing targeted homeownership subsidies, the Congress could alter federal policy to reduce the less targeted subsidies that are now provided for housing. Such changes could be viewed either as a means of financing greater targeted subsidies or as unrelated actions intended to encourage the flow of capital to--and the greater growth of--sectors of the economy other than housing. Since the present system of subsidies for housing was put in place to encourage both residential investment generally and homeownership specifically, reductions in those subsidies would represent a break with past policies. On the other hand, the sharp rise in these subsidies in recent years may make a reexamination of them at this time appropriate. 37/

If the Congress chooses to reduce subsidies for investment in housing, numerous options are available. The examples described below would limit the deductibility of mortgage interest payments from income for tax purposes (the largest present homeownership tax subsidy) or alter the excess bad debt reserve tax deduction now available to thrift institutions, which encourages them to invest in residential mortgages. 38/

---

37. As discussed earlier, tax laws enacted during the past few years have further enhanced the relative incentives for investment in rental housing versus other assets. The Economic Recovery Tax Act of 1981 increased the investment incentives for rental housing as well as for other real and personal property; the Tax Equity and Fiscal Responsibility Act of 1982 then removed some of the incentives for investment in plant and equipment established by the 1981 act. See Patric H. Hendershott and James D. Shilling, "Capital Allocation and the Economic Recovery Tax Act of 1981," Public Finance Quarterly, vol. 10, no. 2, April 1982, pp. 242-73.

38. Other options, not considered here, could reduce indirect encouragements for investment in housing by, for example, eliminating deposit insurance for federally chartered lending institutions. While such a change would eliminate one of the principal advantages that the major mortgage lenders have in attracting deposits, it would also lessen the safety of the dominant investment opportunity available to small savers.

Limiting Mortgage Interest Tax Deductibility. The Congress could lessen the total amount of subsidy to the housing sector--and increase federal revenues as well--by establishing a ceiling on the amount of mortgage interest payments homeowners can deduct from their taxable incomes. Limiting the deductibility of home mortgage interest payments would increase the after-tax cost of ownership, thus decreasing the relative attractiveness of homeownership as an investment and potentially directing some consumer saving toward other types of investments. Capping interest deductibility could also alter home prices by reducing the demand for expensive houses on which mortgage interest payments would be above the ceiling and increasing the relative demand for less expensive houses. These demand shifts, and any associated price changes, could result in capital losses for owners of more expensive houses and capital gains for owners of less expensive houses. Eventually these might be reduced as the supply of housing adjusted, but the adjustment process could take a very long time. Some may regard such gains and losses as inequitable, on the ground that homebuyers assume tax laws will remain constant when they make their purchases.

A ceiling on home mortgage interest payments would impose significant tax increases on taxpayers now benefiting most from deductibility--primarily those with high incomes and with large amounts of mortgage debt. For example, had a $5,000 ceiling on mortgage interest deductibility been in effect in 1981, over 55 percent of the resulting tax increase would have fallen on taxpayers earning $50,000 or more. A $10,000 ceiling would have affected very few taxpayers with incomes under $50,000, with almost 45 percent of the tax increase falling on taxpayers with incomes of $100,000 or more. Because of large increases in interest rates in the past few years, recent homebuyers would be most adversely affected by a ceiling on home mortgage interest payments.

The Congress could consider several variants of the ceiling on mortgage interest deductibility to limit the financial hardship imposed on certain groups of taxpayers. One alternative would be to place a ceiling on the mortgage amount instead of on the amount of mortgage interest that is deductible. Under this option, only interest payments corresponding to a mortgage balance below a certain amount, say $75,000, would be deductible. Establishing a ceiling on the mortgage amount would lessen differences in the treatment of households that bought homes with similar sized mortgages but at different times and therefore with different interest rates. A ceiling on the mortgage amount would not, however, eliminate the differential tax treatment of households that bought similarly priced homes with mortgages above the ceiling at different times. A variation of this approach would be to establish a sliding scale of deductibility with, for example, homeowners able to deduct all interest payments corresponding to the first $75,000 worth of mortgage balance, but progressively smaller shares of the interest payments on mortgage amounts above that level. This option would shield more recent buyers from sizable tax increases but would result in a smaller revenue gain for the government.

A different approach would be to disallow the deduction of, say, 5 percent of annual mortgage interest payments for all households. This would spread the additional tax burden equally across all homeowners who itemize, but would have a small impact on the allocation of credit between housing and other sources since the disincentives to buy expensive homes would be reduced only slightly.

The deductibility of mortgage interest payments also could be limited indirectly by establishing a cap for all nonbusiness, noninvestment interest deductions. The Congress could, for example, establish a $10,000 cap for all interest payments on home mortgages, auto loans and other installment purchases, credit card carryovers, and consumption borrowing taken together. Such a cap would reduce the incentive for all forms of borrowing above the cap. For example, at a 14 percent interest rate, interest on borrowings up to $71,000 would be fully deductible, while at a 10 percent rate, interest on borrowings up to $100,000 would be deductible.

Finally, the deductibility of mortgage interest payments could be allowed only for principal residences. Although this alternative would generate additional revenue, it could result in households with more than one residence purchasing more expensive principal residences and less costly second or more residences than otherwise. In addition, because the change would affect only a small proportion of all homeowners, it would probably have little effect on the overall allocation of capital between housing and other investments.

Increases in federal revenue resulting from any limit on mortgage interest tax deductibility would depend on the level of the ceiling and the form the cap took. For example, according to CBO estimates made in 1982, a $5,000 ceiling on mortgage interest deductions would have increased federal revenues by about $31 billion over a five-year period, while a $10,000 ceiling would have increased federal revenues by about $6 billion over five years. According to an estimate prepared one year later, a $10,000 cap on all nonbusiness, noninvestment interest deductions would increase federal revenues by $9 billion over a five-year period.

Modifying the Excess Bad Debt Reserve Tax Deduction. Overall federal subsidies to the housing sector could also be altered by modifying Section 593 of the Internal Revenue Code which establishes an excess bad debt reserve tax deduction for thrift institutions. Under current law, savings and loan associations and mutual savings banks may deduct as much as 34 percent of their total taxable incomes as additions to their bad debt reserves if specified percentages of their assets are held in mortgages or other qualifying forms. Savings and loan associations must hold 82 percent of their assets in qualifying forms to take the full deduction, and the deduction is gradually decreased until it reaches zero when qualifying assets amount to 60 percent of an institution's total. Mutual savings banks may take the full deduction if they hold 72 percent of their assets in qualifying forms, and lose the deduction entirely if 50 percent or less of their assets are qualifying.

Although the federal revenue loss resulting from these provisions is relatively small--an estimated $335 million in fiscal year 1983--the potential effect of the excess bad debt reserve tax deduction on the investment behavior of thrift institutions is probably considerable. The importance of this deduction may help account for the numerous applications during the first quarter of 1983 for charter conversions by savings and loan associations seeking to become mutual savings banks, allowing them to take the maximum tax deduction while holding a smaller percentage of qualifying assets. 39/

The excess bad debt reserve tax deduction could be modified in a variety of ways to lessen either the incentive for thrift institutions to invest in housing or the resulting revenue loss from the deduction. Some options to accomplish the former would work against achieving the latter, however. Specific options for altering the deduction include: lowering the maximum qualifying levels of assets, lowering the percent of taxable income deductible as an addition to the institution's bad debt reserve, or reducing both.

Lowering the maximum qualifying levels of assets while retaining the percentage of taxable income that is deductible would probably lessen the amount of investment in housing by thrift institutions but would not reduce the federal revenue loss. Lowering the maximum percentage of taxable income deductible as an addition to an institution's bad debt reserve, while retaining the existing maximum qualifying levels of assets, would lessen the federal revenue loss and reduce the incentive for thrift institutions to hold the maximum percentage of qualifying assets--thereby potentially decreasing housing investment. Lowering both the maximum qualifying levels of assets and the percent of taxable income deductible would probably lessen the amount of investment in housing still further, while reducing the federal

---

39. As described in Chapter IV, such charter conversions were authorized by the Garn-St. Germain Depository Institutions Act of 1982.

revenue loss. 40/ Lessening the amount of investment in housing--through any of these approaches--could also result in somewhat higher mortgage interest rates and in the reallocation of funds to other sectors of the economy, if the total supply of mortgage funds was also reduced.

Another approach would be to repeal the bad debt reserve tax deduction--increasing federal revenues and lessening the incentive for thrift institutions to invest in housing. If the deduction was repealed, it could then be replaced by a generally available tax credit for all interest income earned on mortgages and MBSs. Such a tax credit would benefit all mortgage investors equally--spreading the subsidy from the tax treatment of mortgage interest among a greater number of institutions and individuals than currently receive it. On the other hand, a mortgage interest tax credit would continue to favor mortgage investment over other credit uses such as business plant and equipment.

Either eliminating the bad debt reserve tax deduction or replacing it with a more efficient subsidy would further federal deregulation of the housing finance system.

---

40. Another change would be to make the qualifying level of assets the same percentage for both savings and loan associations and mutual savings banks. This would eliminate the existing incentive for savings and loan associations to recharter as mutual savings banks to be able to take the maximum tax deduction on the basis of a smaller percentage of qualifying assets.

APPENDIX A. ADDITIONAL INFORMATION ON FEDERAL HOUSING FINANCE INSTITUTIONS

MORTGAGE INSURANCE AGENCIES

The Federal Housing Administration

The 1934 National Housing Act established the Federal Housing Administration (FHA) to insure residential mortgages and thereby encourage their trading in the secondary mortgage market. Because the private mortgage associations authorized by Title III of the act in order to stimulate a private secondary market did not develop, the secondary mortgage market became primarily a federally supported entity.

The FHA, now part of the U.S. Department of Housing and Urban Development (HUD), has developed 40 mortgage/loan insurance programs in four separate insurance funds--the Mutual Mortgage Insurance Fund, the Cooperative Management Housing Insurance Fund, the General Insurance Fund, and the Special Risk Insurance Fund.

The Mutual Mortgage Insurance Fund (MMIF), the largest of the FHA funds, includes the major single-family insurance program--Section 203(b) of the 1934 National Housing Act, as amended. As a mutual fund, the MMIF pays participants under the Section 203(b) program a rebate of premiums not required for expenses or losses.

The Cooperative Management Housing Insurance Fund (CMHIF), also a mutual fund, provides mortgage insurance for management-type cooperatives and supplementary loans under Section 213 of the 1934 National Housing Act, as amended. Under the Section 213 program, HUD insures mortgages made by private lending institutions on cooperative housing projects of five or more dwelling units to be occupied by members of nonprofit cooperative ownership housing corporations. The supplementary loans may finance: new construction, rehabilitation, acquisition, improvement, or repair of a project already owned, and resale of individual memberships; construction of projects composed of individual family dwellings to be bought by individual members with separately insured mortgages; and construction or rehabilitation of projects that the owners intend to sell to nonprofit cooperatives.

The General Insurance Fund (GIF) provides insurance in a wide variety of special purpose programs including insurance programs for loans on property repairs and improvements; on basic and special purpose multifamily housing; on urban renewal, middle-income, and armed forces housing; and on war and defense housing. The GIF has incurred financial losses over the years.

The Special Risk Insurance Fund (SRIF) insures mortgages in older, declining urban areas which otherwise would not be eligible for mortgage insurance (Section 223(e)), and mortgages covering experimental housing where strict adherence to state or local building regulations is not observed (Section 233). Mortgagors who are eligible for mortgage insurance after receiving housing counseling (Section 237) and those receiving interest reduction payments (Sections 235 and 236) also receive insurance through this fund. The SRIF has also incurred financial losses from its operations.

The FHA meets operating expenses in excess of premium collections by its funds in several ways. Prior to 1976, the FHA financed losses mainly by using its open-end Treasury borrowing authority. Since 1976, the FHA has been authorized to receive annual appropriations to restore losses sustained as a result of the operations of the General Insurance and the Special Risk Insurance Funds.

The Veterans Administration

Under the Veterans Administration's (VA) loan guarantee program--established by the 1944 Servicemen's Readjustment Act--assistance is provided to eligible home purchasers by substituting the government's guarantee of payment on private loans for down payments and other requirements associated with conventional mortgage transactions. As a result of the Veterans Housing Act of 1970, eligible veterans and active-duty service personnel also can receive the VA guarantee on loans for mobile homes, for refinancing, and for condominiums, as well as for single-family homes.

The 1974 Veterans Housing Act further expanded loan eligibility under the VA guarantee program. The act increased the pool of condominium projects eligible for VA-approved loans and allowed veterans who had previously obtained a loan to regain entitlement for another loan if the original property is disposed of and the loan is paid in full, or if another eligible veteran assumes the balance of the VA loan and substitutes his/her own entitlement. The 1974 act also allowed nonsupervised lenders who meet VA standards to make guaranteed loans without prior VA approval.

The Omnibus Reconciliation Act of 1982 established a fee of one-half percent of the principal value of the loan for most loans closed between October 1, 1982, and September 30, 1985, which may be added to the loan amount.

SECONDARY MARKET ENTITIES

The Government National Mortgage Association

The Government National Mortgage Association (GNMA)--an agency of the U.S. Department of Housing and Urban Development--was established in 1968 to assume the government functions of the Federal National Mortgage Association (FNMA), which was privatized at the same time. 1/

The GNMA has four primary functions, two of which were inherited from the FNMA. Under the special assistance function programs, which are similar to predecessor programs operated by the FNMA, the GNMA purchases and resells at a loss privately written reduced-interest mortgages to provide support for types of housing for which financing is not readily available, such as rental housing for low-income families. Under the management and liquidation function--also inherited from the FNMA--the GNMA manages and liquidates a portfolio of federally owned mortgages with minimum adverse effect on the home mortgage market and minimum loss to the government. GNMA also has authority under the emergency mortgage purchase assistance program to provide countercyclical housing assistance. Finally, the GNMA operates the mortgage-backed security (MBS) program, discussed in Chapters III and IV of the paper.

The GNMA MBS program is self-supporting from its fee revenue and has made several innovations in the market for MBSs. Revenues in the GNMA MBS program come from an issuer application fee, a commitment application fee, and a fee of 0.06 percent of the security's value paid by the institutional issuer for the GNMA guarantee. 2/ The GNMA MBS program has developed both the modified passthrough security--which channels principal and interest payments to investors even if borrowers fail to make monthly payments on the underlying mortgages--and an organized futures market in MBSs. The FNMA handles the daily administration of the GNMA MBS program.

---

1. Both of these changes were accomplished by amending Title VIII of the 1934 National Housing Act in the 1968 Housing and Urban Development Act.

2. A fee of 0.44 percent of the security's value is paid to the issuer for servicing the mortgage pool. The Issuer Application Fee and the Commitment Application Fee are discussed in Chapters IV and V.

The Federal National Mortgage Association

The Federal National Mortgage Association (FNMA) was established in 1938 as a wholly-owned public subsidiary of the Reconstruction Finance Corporation (RFC), a federally chartered public corporation. The FNMA was chartered as a federally owned and operated national mortgage company to trade mortgages backed by the federal government because the RFC Mortgage Corporation--another subsidiary of the RFC established in 1935--had failed to establish a private secondary market in residential mortgages. Although the FNMA was intended to be a private entity and to pay for its operations with fees, it developed instead as a publicly owned agency. Eventually, the 1968 Housing and Urban Development Act established the FNMA as a private taxpaying corporation by transferring its public functions to the newly established GNMA.

The FNMA is authorized to service, lend on the security of, or otherwise deal in both government-insured or -guaranteed and conventional mortgages. 3/ The FNMA finances its mortgage holdings by issuing debt in the capital market and by issuing common stock that is traded on the New York Stock Exchange.

In recent years, the FNMA has operated in deficit because it holds a portfolio dominated by its past purchases of low-yielding, fixed-rate, 30-year mortgage loans. Traditionally, the FNMA has sold less than 10 percent and often less than 1 percent of all mortgages it has purchased. By the end of 1982, the FNMA had lessened the size of its deficit, in large measure by altering the mix of its portfolio holdings, and showed a profit of $15.0 million in the first quarter of 1983, the first quarterly profit since the fourth quarter of 1980.

The Federal Home Loan Mortgage Corporation

The Federal Home Loan Mortgage Corporation (FHLMC) is a federally chartered, tax-exempt corporation created to correct imbalances in the supply of conventional mortgage credit within the thrift industry by moving funds from capital surplus to deficit areas and by attracting funds into mortgage lending from sources outside the thrift industry. The FHLMC was established under the control of the Federal Home Loan Bank Board (FHLBB) by Title III of the Emergency Home Finance Act of 1970.

---

3. The FNMA began to purchase conventional mortgages in 1972.

26-334 O - 83 - 7

The FHLMC is authorized to purchase and make commitments to purchase residential mortgages approved by the Secretary of HUD for participation in any federal mortgage insurance program, and residential mortgages from any Federal Home Loan Bank or member thereof. Residential mortgages from the Federal Savings and Loan Insurance Corporation (FSLIC), or from any other financial institution, the deposits or accounts of which are insured by an agency of the U.S. government, also may be purchased by the FHLMC. The FHLMC may borrow, give security, pay interest or other return, issue notes, debentures, bonds, or other obligations or other securities including without limitation MBSs to be guaranteed by the GNMA. The FHLMC operates a daily program for the purchase of mortgages with a fee for participation.

APPENDIX B. RECENT HOUSING FINANCE LEGISLATION AND CHRONOLOGY OF REGULATORY ACTION

TABLE B-1. RECENT HOUSING FINANCE LEGISLATION

Legislation and Date Enacted[a]	Provisions
Financial Institutions Regulatory and Interest Rate Control Act of 1978--November 10, 1978	Enabled the FSLIC to facilitate merger, consolidation, or acquisition of assets of an association following its default. Strengthened FHLBB powers over association officers, directors, and related organizations. Created the interagency Federal Bank Examination Council to encourage uniformity in financial institution supervision.
Housing and Community Development Amendments of 1979--December 21, 1979	Increased one-family home loan limits for federal associations. Raised FHA loan limits and expanded the FHA graduated payment mortgage (GPM) program. Raised FNMA and FHLMC loan ceilings. Exempted FHA loans from state usury ceilings.
Depository Institutions Deregulation and Monetary Control Act of 1980--March 31, 1980	Extended savings interest rate control for all depository institutions and the thrift institution differential for six years. Shifted rate-setting authority from individual agencies to a Depository Institutions Deregulation Committee. Increased FSLIC and FDIC insurance for individually owned savings accounts from $40,000 to $100,000. Extended the federal override of state usury ceilings on certain mortgage and other loans. Authorized nationwide NOW accounts effective at year-end 1980 and established levels of reserves that must be held against NOW balances. Authorized investment of up to 20 percent of assets of federal associations in consumer loans, corporate debt securities, and commercial paper. Eased or removed lending restrictions, including geographical limitations, loan-to-value ratios, and treatment of single-family loans exceeding specified dollar amounts.

(Continued)

TABLE B-1. (Continued)

Legislation and Date Enacted[a]	Provisions
Housing and Community Development Act of 1980--October 8, 1980	Permitted negotiated interest rates on certain FHA loans. Mandated HUD action to either disapprove or approve initiation of a mortgage-backed securities (MBS) program by the FNMA.
Omnibus Reconciliation Act of 1980--December 5, 1980	Limited the issuance by states and municipalities of tax-exempt mortgage revenue bonds for housing purposes. Provided for both the limits and tax exemption of such bonds to expire in three years.
Economic Recovery Tax Act of 1981--August 13, 1981	Created the All Savers certificate. Increased annual contribution limits on Individual Retirement Accounts (IRAs).
Veterans' Disability Compensation, Housing, and Memorial Benefits Amendments of 1981--October 17, 1981.	Established a graduated payment plan as part of the VA loan guaranty program.
Garn-St. Germain Depository Institutions Act of 1982--October 15, 1982	Provided capital assistance through net worth certificates to financially weak depository institutions that have suffered earnings and capital losses. Mandated the creation of a deposit instrument equivalent to money market mutual funds. Advanced the deadline to eliminate interest rate differentials from March 31, 1986, to January 1, 1984. Provided expanded authority to make commercial, agricultural, and corporate loans to federal savings and loans and mutual savings banks. Authorized the change between chartering status as a federal savings and loan and a federal savings bank and/or between the stock and mutual form of chartering. Authorized the FNMA to issue preferred stock and made such stock freely transferable.

---

a. Date enacted is the date on which legislation was signed into law.

TABLE B-2. CHRONOLOGY OF RECENT HOUSING FINANCE REGULATIONS

The Federal Housing Administration	
May 20, 1982	Negotiated rates on a limited number (the greater of 50,000 or 10 percent of the Section 203 mortgages insured in the previous fiscal year) of FHA-insured mortgages were allowed.
May 26, 1982	Ratio of housing expense to borrower income allowed on FHA-insured mortgage loans was raised from 35 to 38 percent of net effective income. Limit on housing expenses and other recurring charges was raised from 50 to 53 percent.
June 4, 1982	Two versions of the growing equity mortgage became eligible for FHA insurance under Section 245 Graduated Payment Mortgage program.
September 8, 1982	Collections of up-front lump-sum premium established by the Omnibus Budget Reconciliation Act of 1982.
Spring 1983	Delegated processing by lenders with five years of conventional single-family loan origination experience was allowed. In-house appraisals can be performed by lenders with property appraisers on their staffs.
The Veterans Administration	
October 17, 1981	Graduated payment mortgage loan plans became eligible for VA guarantee.
May 26, 1982	Growing equity mortgages became eligible for the VA home loan guarantee.
September 8, 1982	Omnibus Budget Reconciliation Act of 1982 levied 1/2 percent fee on guarantees issued on loans closed between October 1, 1982, and September 30, 1985.

(Continued)

TABLE B-2. (Continued)

October 27, 1982	Restriction against VA guarantee of loans with following characteristics was lifted: o loans on homes in communities with age restrictions; o loans on homes with resale price restrictions; o mortgage loans provided by state and local housing agencies at below-market-interest rates.

The Government National Mortgage Association

April 23, 1979	Securities backed by five-year graduated payment mortgage loans, insured by the FHA, became eligible for the GNMA guarantee.
May 17, 1982	Securities backed by pools of graduated payment mortgage loans, guaranteed by the VA, became eligible for the GNMA guarantee.
October 1, 1982	Fees under the GNMA MBS guarantee program were increased. A new Issuer Application fee of \$250 was established, and the Commitment Application fee was increased from a flat \$500 to the following: o \$500 for the first \$1.5 million of commitment amounts, plus o \$200 for each \$1 million (or part thereof) above \$1.5 million.
January 1983	GNMA-guaranteed MBSs were first sold by investment brokers (Merrill Lynch, Dean Witter, Prudential-Bache, and Shearson/American Express) to general public investors in any amount over \$1,000.
February 1, 1983	Securities backed by pools including growing equity mortgages and ten-year graduated payment mortgages (i.e., payments will increase 2-3 percent each year for ten years) became eligible for the GNMA guarantee.

(Continued)

TABLE B-2. (Continued)

July 1, 1983	GNMA II--a new MBS program with jumbo pools, a central paying agent, and electronic funds transfer among its features--was introduced.

The Federal National Mortgage Association

December 1981	Securities or trust certificates representing fractional interests in pools of conventional home mortgages originated by primary market lenders (e.g., savings and loan associations, mortgage bankers) were first issued.
March 1982	Program initiated in which state pension plans receive FNMA securities backed by mortgage loans made through savings and loan associations using state pension funds.
June 1982	Purchase of second mortgage participations and loans, both fully amortized and balloon payment, authorized.
July 1982	First purchases of cooperative housing share loans made.
	Purchase and commitment-to-purchase program initiated for growing equity mortgages with fixed schedules and for rapid payoff loans.
September 1, 1982	Securities backed by growing equity mortgages and rapid payoff loans first issued with the FNMA guarantee.
	FHA/VA loans of any age and interest rates first exchanged for the FNMA MBS or trust certificate.
October 15, 1982	Requirement lifted that all conventional fixed-rate mortgages bought by the FNMA be called payable in full on their seventh anniversary.

(Continued)

TABLE B-2. (Continued)

October 1982	Commitments made to purchase loans to help builders sell their inventory through the Home Mortgage Access Corporation (HOMAC), a subsidiary of the National Association of Home Builders (NAHB).
November 22, 1982	Resale-refinancing program for new mortgage loans on homes for which the FNMA holds the existing mortgages expanded to refinance conventional, FHA, and VA existing mortgages with conventional mortgage loans.
December 22, 1982	Maximum debt-to-capital ratio raised by HUD from 25-to-1 to 30-to-1.
March 1983	Biweekly Free Market System auction for mortgages terminated.
March 15, 1983	Major home sellers--large builders and realty chains and others associated with home finance, such as mortgage insurers, groups of small lenders, and regional and national trade groups--authorized to buy commitments directly from FNMA.

The Federal Home Loan Mortgage Corporation

August 1981	Swap program instituted.
July 1982	Growing equity mortgages first bought for pools to back participation certificates.
October 15, 1982	Acceptable loan values on refinancing mortgages increased from 80 percent to 90 percent of the appraisal value.
November 1, 1982	One-half percent fee per dollar value of mortgage purchased from home lenders not members of the federal savings and loan insurance system canceled.

(Continued)

TABLE B-2. (Continued)

January 1983	Agreement made for standby commitments to purchase loans made to help builders sell their inventory through the Home Mortgage Access Corporation (HOMAC), a subsidiary of the National Association of Home Builders (NAHB).
March 1, 1983	Adjustable rate mortgage program which limits annual rate changes to 2 percent was eliminated.
March 15, 1983	Weekly auction replaced by a daily administered-price offering system.
April 1983	Fifteen-year fixed-rate mortgage program now offered through NAHB's HOMAC program opened to all seller-servicers.
	Two new adjustable rate mortgage programs--with rates tied to three-year and five-year Treasury securities--made available.
	FHA/VA loans accepted in the SWAP program.
June 1983	Collateralized mortgage obligations (CMOs), or mortgage-backed bonds collateralized by long-term, fixed-rate mortgages, were first offered. The CMOs were issued in three classes with fast-, intermediate-, and slow-pay characteristics and with all the classes receiving semiannual payments of both interest and principal.

APPENDIX C. ALTERNATIVE MORTGAGE INSTRUMENTS

TABLE C-1. SUMMARY OF ALTERNATIVE MORTGAGE INSTRUMENTS

		Status		
	Distinguishing Feature	Federally Chartered Thrifts	National Banks	Prevalence
Variable Rate Mortgage (VRM)	Mortgage rate is linked to a reference rate and may change during life of loan.	Authorized nationwide in 1979; restrictions relaxed in 1981.	Authorized nationwide in 1981.	Variants popular in California, Ohio, and Wisconsin.
Graduated Payment Mortgage (GPM)	Payments increase gradually in early years of loan and then level off.	Authorized nationwide in 1979.	Subject to state laws.	California, Florida, Texas, Colorado, and Arizona account for more than one-half of all FHA-insured GPMs.
Shared Appreciation Mortgage (SAM)	Lender shares in appreciation of the property.	Regulations proposed in 1980; not yet authorized.	Subject to state laws.	Incipient; long used in non-residential mortgages.
Growing Equity Mortgage (GEM)	Increases in monthly payments, which are tied to the market, are used to reduce principal and speed up loan amortization.	Authorized under laws existing for GPMs.	Subject to state laws.	
Price Level Adjusted Mortgage (PLAM)	Payments are constant in real terms.	Discussion stage.	Discussion stage.	

---

a. Standard, fixed payment mortgage.

Advantages Compared With SFPM[a]		Disadvantages Compared With SFPM[a]	
Borrowers	Lenders	Borrowers	Lenders
Slightly lower initial interest rate; increased availability of funds.	Interest rate risk is reduced.	Increased interest rate risk.	Lack of standardization makes it difficult for investors to evaluate loans.
Reduced payments in early years.	May earn higher long-run interest rate.	Payments may rise faster than income.	Negative amortization in early years.
Substantially lower interest rate.	Interest rate risk is reduced.	Reduction of capital gains on appreciation; need to pay large amount at end of loan period.	Uncertain return on investment; reduced cash flow in early years.
Eliminates tilt in real payments stream and increases equity in home quickly.	Interest rate risk is reduced.	Payments may rise faster than income.	Return on investment can be uncertain because it is largely determined by skill of lender at reinvesting principal repayments.
Eliminates tilt in real payments stream.	Interest rate risk is reduced; certainty about the real value of payments.	Inflation-induced increase in equity is eliminated.	Reduced cash flow in early years.

BEST COPY AVAILABLE

APPENDIX D. ADDITIONAL INFORMATION ON SOURCES AND FLOWS OF MORTGAGE FUNDS

TABLE D-1. ORIGINATIONS OF FEDERAL HOUSING ADMINISTRATION-INSURED AND VETERANS ADMINISTRATION-GUARANTEED RESIDENTIAL MORTGAGE LOANS BY PROPERTY TYPE, 1970-1982
(In millions of dollars)

	VA-Guaranteed Loans[a]		FHA-Insured Single-Family Loans				FHA-Insured Multifamily Loans			
Years	Number	Value	Number	Value	Value as Percent of Total[c]	Total Value of Single-Family Loans[d]	Number	Value	Total Value as Percent of Total[e]	Value of Multi-family Loans[f]
1970	186,187	3,682.3	471,981	8,068.7	22.7	35,600.0	2,039	2,852.4	32.4	8,800.0
1971	197,834	4,111.6	565,417	10,374.5	17.9	57,800.0	2,324	3,672.3	29.4	12,500.0
1972	359,001	7,860.7	427,858	8,067.1	10.6	75,900.0	2,000	3,127.7	20.3	15,400.0
1973	365,122	8,357.5	240,004	4,473.3	5.7	79,100.0	1,247	2,047.7	14.6	14,000.0
1974	311,250	7,709.4	195,827	3,932.9	5.8	67,500.0	546	977.0	7.9	12,300.0
1975	290,191	8,091.4	255,061	6,166.1	7.9	77,900.0	346	813.4	7.7	10,600.0
1976	326,727[b]	9,951.2[b]	250,808	6,362.1	5.6	112,800.0	706	1,663.5	13.5	12,300.0
1977	382,586	13,135.8	321,118	8,840.8	5.5	162,000.0	982	2,538.7	16.1	15,800.0
1978	380,869	14,658.7	334,108	11,140.0	6.0	185,000.0	1,178	5,208.9	31.8	16,400.0
1979	364,578	16,072.0	457,726	18,184.2	9.8	186,600.0	1,078	3,287.1	21.6	15,200.0
1980	297,447	14,815.3	381,169	16,458.5	12.3	133,800.0	1,321	4,227.6	33.8	12,500.0
1981	187,628	10,008.9	224,829	10,278.1	10.5	98,212.0	1,219	3,680.7	31.7	11,600.0
1982	103,439	5,541.9	166,734	8,087.1	8.5	94,918.0	1,575	4,507.3	40.1	11,234.0

SOURCE: Data from the U.S. Department of Housing and Urban Development and the Veterans Administration.

a. Because the number and value of VA-guaranteed loans are fiscal-year data, the value of these loans as a percent of all single-family (i.e., one- to four-unit) loans--a figure available only by calendar year--is not calculated. Loans for mobile homes are included as of 1971. Loans for farms and businesses, no longer made as of 1974, are excluded in the early years.

b. Data for the transition quarter July 1 through September 30, 1976, when the definition of the fiscal year was changed, are not included.

c. Percentage of the total value of one- to four-unit residential mortgage loans originated each year. Total includes FHA-insured, VA-guaranteed and conventional mortgage loans.

d. Total value of one- to four-unit loans includes FHA-insured, VA-guaranteed, and conventional mortgage loans originated each year.

e. Percentage of the total value of multifamily loans originated each year. Total includes FHA-insured and conventional mortgage loans.

f. Total value of multifamily loans includes FHA-insured and conventional mortgage loans originated each year.

BEST COPY AVAILABLE

TABLE D-2. GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA) MORTGAGE-BACKED SECURITIES PROGRAM--COMMITMENTS AND SECURITIES GUARANTEED, 1968-1982 (In millions of dollars)

Year	Commitments	Securities Guaranteed
1968	N/A[a]	N/A[a]
1969	N/A[a]	N/A[a]
1970	1,126.2	452.0
1971	4,373.6	2,702.2
1972	3,909.5	2,661.9
1973	5,588.0	2,952.5
1974	6,202.5	4,552.7
1975	10,448.6	7,447.3
1976	25,395.3	13,764.4
1977	31,077.5	17,439.8
1978	35,012.4	15,358.4
1979	56,447.0	24,939.9
1980	57,704.0	20,646.8
1981	34,542.6	14,257.3
1982	38,865.4	16,011.5

SOURCE: Government National Mortgage Association data.

a. N/A = not available. The GNMA was founded in 1968 and data for the MBS program are not available for that year and for 1969.

BEST COPY AVAILABLE

TABLE D-3. FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA) PURCHASES AND SALES OF ONE- TO FOUR-UNIT MORTGAGES, 1968-1982 (In millions of dollars)

	Purchases				Sales
Years	FHA	VA	Conventional	Total	
1968	1,291.0	646.8	N/A[a]	1,937.8	0.4
1969	2,789.9	1,311.7	N/A[a]	4,101.6	0.0
1970	3,490.1	1,287.4	N/A[a]	4,777.4	20.3
1971	2,068.2	674.2	N/A[a]	2,742.4	335.5
1972	1,775.4	765.3	55.1	2,595.8	211.2
1973	1,605.1	1,626.0	938.6	4,169.6	70.8
1974	1,278.4	2,339.4	1,128.3	4,746.0	4.3
1975	1,331.3	1,767.3	547.2	3,645.8	2.0
1976	403.4	420.3	2,512.9	3,336.6	86.1
1977	1,093.4	1,190.2	2,366.4	4,650.0	81.6
1978	4,309.3	2,310.6	5,681.7	12,301.7	9.0
1979	4,535.3	852.4	5,410.2	10,797.9	21.8
1980	3,477.9	1,794.6	2,801.8	8,074.3	0.6
1981	1,441.8	842.2	3,827.0	6,111.0	9.3
1982	577.4	300.4	14,288.5	15,106.3	2,071.3

SOURCE: Federal National Mortgage Association data.

a. The FNMA did not purchase conventional loans (i.e., loans neither guaranteed nor insured by a federal agency) until 1972.

BEST COPY AVAILABLE

TABLE D-4. FEDERAL HOME LOAN MORTGAGE CORPORATION (FHLMC) MORTGAGE ACTIVITY: PURCHASES, SALES, AND HOLDINGS BY TYPE, 1970-1982 (In millions of dollars)

	Transactions (during period)				Holdings (end of period)		
	Purchases		Sales				
Years	FHA/VA	Conventional[b]	FHA/VA	Conventional[b]	FHA/VA[c]	Conventional[b]	Total
1970[a]	325.0	N/A	N/A	N/A	325.0	N/A	325.0
1971	564.0	214.0	48.0	65.0	821.0	147.0	968.0
1972	833.0	464.0	90.0	317.0	1,502.0	286.0	1,788.0
1973	335.0	999.0	0.0	409.0	1,800.0	804.0	2,604.0
1974	261.0	1,929.0	0.0	53.0	1,961.0	2,625.0	4,586.0
1975	119.0	1,594.0	70.0	1,451.0	1,881.0	3,106.0	4,987.0
1976	20.0	1,107.0	35.0	1,762.0	1,675.0	2,594.0	4,269.0
1977	20.0	4,140.0	7.0	4,633.0	1,450.0	1,817.0	3,267.0
1978	0.0	596.0	0.0	1,040.0	1,299.0	1,792.0	3,091.0
1979	0.0	5,621.0	0.0	4,544.0	1,159.0	2,893.0	4,052.0
1980	0.0	3,722.0	0.0	2,526.0	1,090.0	3,966.0	5,056.0
1981	0.0	3,800.0	0.0	3,532.0	1,047.0	4,190.0	5,237.0
1982	0.0	23,673.0	0.0	24,169.0	1,009.0	3,724.0	4,733.0

SOURCE: Federal Home Loan Bank Board data.

N/A = Not available.

[a] Data for 1970 include only the period beginning November 26 when the FHLMC first became operational. Data for other years are full-year figures.

[b] Includes participations as well as whole loans for mortgages neither guaranteed nor insured by a federal agency (i.e., conventional mortgage loans). Participation certificates are reflected in figures for 1971-1982. Guaranteed mortgage certificates are reflected beginning in 1975.

[c] Includes loans used to back bond issues guaranteed by the GNMA.

TABLE D-5. DISTRIBUTION OF ORIGINATIONS OF LONG-TERM MORTGAGE LOANS ON ONE- TO FOUR-UNIT HOUSES[a] BY TYPE OF FINANCIAL INSTITUTION, 1970-1982 (In percent)

Year	Percent Distribution					Total Value of Originations (billions of dollars)
	Savings and Loan Associations	Mutual Savings Banks	Commercial Banks	Mortgage Companies[b]	Other[c]	
1970	41.6	5.9	21.9	25.0	5.6	35.6
1971	46.0	6.1	21.8	21.6	4.5	57.8
1972	48.4	6.7	23.3	17.5	4.1	75.9
1973	48.5	7.5	23.8	16.1	4.1	79.1
1974	45.8	5.8	23.9	19.3	5.2	67.5
1975	52.9	5.5	18.5	18.0	5.1	77.9
1976	54.9	5.7	21.7	13.9	3.8	112.8
1977	53.3	5.4	22.7	15.9	2.7	162.0
1978	48.6	5.1	23.7	18.6	4.0	185.0
1979	44.4	4.8	21.8	24.3	4.7	186.6
1980	45.7	4.0	21.5	22.0	6.8	133.8
1981	42.8	4.1	22.1	24.4	6.6	98.2
1982	36.7	4.3	24.5	29.4	5.1	94.9

SOURCE: Data from U.S. Department of Housing and Urban Development.

a. Only nonfarm houses are included.

b. Mortgage companies include all mortgage banking firms that originate mortgages for resale.

c. Other institutions include: life insurance companies; private, non-insured pension plans; real estate investment trusts; state and local retirement plans; federally sponsored credit agencies; and state and local credit agencies.

TABLE D-6. DISTRIBUTION OF NET ADDITIONS TO HOME MORTGAGE DEBT, BY TYPE OF INSTITUTION, 1970-1982
(In percent)

Year	Depository Institutions[a/]			Federally Sponsored Credit Agencies[b/]	Mortgage Pools[c/]	Households[d/]	Pension Plans[e/]	Other[f/]
	Savings and Loan Associations	Mutual Savings Banks	Commercial Banks					
1970	45.3	7.2	5.8	30.8	8.1	-0.6	0.4	3.0
1971	54.9	4.0	19.0	6.9	14.3	10.1	-0.7	-8.5
1972	56.3	6.3	20.6	4.2	9.8	7.6	-0.8	-4.0
1973	48.7	5.9	24.9	7.9	7.2	5.1	-0.1	0.4
1974	38.7	2.0	18.4	15.2	9.1	17.9	0.1	-1.4
1975	52.8	1.8	4.8	5.8	16.6	12.6	-1.2	6.8
1976	56.3	4.7	14.1	0.7	18.2	7.4	-0.1	-1.3
1977	51.2	5.1	19.4	0.5	16.2	5.8	0.1	1.7
1978	40.2	4.7	21.3	8.0	11.0	10.2	0.2	4.4
1979	32.3	2.3	16.8	7.7	18.3	13.5	0.5	8.6
1980	26.8	1.1	11.3	8.0	19.5	21.4	0.8	11.1
1981	17.6	0.7	16.0	6.0	18.5	26.9	0.4	13.9
1982[g/]	-8.0[h/]	-3.7[h/]	18.0	12.2	38.3	24.1	0.6	18.5

SOURCE: Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

a. Mortgage-backed securities are not included as mortgage debt holdings of depository institutions.

b. The federally sponsored credit agencies include the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Federal Land Banks, the Federal Intermediate Credit Banks, and the Banks for Cooperatives.

c. Mortgages in pools backing passthrough securities issued and/or guaranteed by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Farmers Home Administration, and the Federal National Mortgage Association.

d. Mortgage debt held by households that financed the sale of a unit to someone.

e. Includes private and public pension plans.

f. Other institutions include: life insurance companies, real estate investment trusts, state and local credit agencies, credit unions, finance companies, and U.S. agencies for which amounts are small or separate data are not readily available.

g. Based on activity through the first six months of 1982.

h. Figures are negative because of the FHLMC SWAP program.

TABLE D-7. DISTRIBUTION OF HOME MORTGAGE DEBT OUTSTANDING, BY TYPE OF INSTITUTION, 1970-1982 (In percent)

Year	Depository Institutions[a/]							
	Savings and Loan Associations	Mutual Savings Banks	Commercial Banks	Federally Sponsored Credit Agencies[b/]	Mortgage Pools[c/]	Households[d/]	Pension Plans[e/]	Other[f/]
1970	41.8	14.2	14.2	5.2	1.0	7.8	1.6	14.2
1971	43.0	13.3	14.7	5.4	2.2	8.0	1.4	12.0
1972	44.6	12.4	15.4	5.2	3.1	8.0	1.1	10.2
1973	45.0	11.7	16.4	5.5	3.6	7.7	1.0	9.1
1974	44.5	10.9	16.6	6.3	4.0	8.5	0.9	8.3
1975	45.2	10.1	15.6	6.3	5.1	8.8	0.7	8.2
1976	46.5	9.5	15.4	5.6	6.6	8.7	0.6	7.1
1977	47.2	8.8	16.0	4.9	8.1	8.2	0.5	6.3
1978	46.2	8.2	16.8	5.3	8.5	8.5	0.5	6.0
1979	44.3	7.4	16.8	5.6	9.9	9.2	0.4	6.4
1980	42.5	6.8	16.2	5.8	10.9	10.4	0.6	6.8
1981	40.7	6.4	16.2	5.9	11.4	11.5	0.5	7.4
1982[g/]	37.8	5.9	16.0	6.4	13.5	12.4	0.5	7.5

SOURCE: Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

NOTE: Components may not add to 100 because of rounding.

a. Mortgage-backed securities are not included as mortgage debt holdings of depository institutions.

b. The federally sponsored credit agencies include the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Federal Land Banks, the Federal Intermediate Credit Banks, and the Banks for Cooperatives.

c. Mortgages in pools backing passthrough securities issued and/or guaranteed by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Farmers Home Administration, and the Federal National Mortgage Association.

d. Mortgage debt held by households that financed the sale of a unit to someone.

e. Includes private and public pension plans.

f. Other institutions include: life insurance companies, real estate investment trusts, state and local credit agencies, credit unions, finance companies, and U.S. agencies for which amounts are small or separate data are not readily available.

g. Based on activity through the first nine months of 1982.

U.S. GOVERNMENT PRINTING OFFICE : 1983 O - 26-334